RSW INVESTMENTS

# 2010: RSW Perspective

## A Year In Review

What a difference 9 months makes! It was only back in March 2009, when we lived in a world where any leverage was too large. However, as the markets have rebounded some investors have returned to a mentality that no risk is too big. So what lies ahead? Will there be a robust economic recovery? Soaring inflation accompanied by sky-rocketing interest rates? Swelling number of Municipal bond defaults? First, as is RSW's tradition let's reflect back on our forecasts for 2009, before we weigh-in with our 2010 predictions.

As a whole, our 2009 prognostications hit the target as we correctly anticipated the following:

- The federal funds target rate during 2009 will remain at or near zero and possibly maintain at this level for years.
- Comparisons to the Great Depression should fall out of fashion.
- Deflationary forces will remain.
- During the year, there will be a renewed concern about hyperinflation as the Federal Reserve throws everything including the kitchen sink to save the financial system. Furthermore, we felt that although it may be counterintuitive, all asset classes outside of U.S. Treasuries should welcome this development.
- Ten year U.S. Treasury bond yields should move back to a range of 3.50% to 4% from the December 2008 close of 2.21%. In fact, during 2009 the 10-year yield did reach 3.95%.
- The number of municipalities that will experience credit downgrades may be well above average.
- We believed that Municipal bond prices could rally sharply even if US Treasury bond yields lurched toward 4%.

## A Year In Preview
## 2010 Forecasts

- Growth will be positive in 2010, but will still remain below the trend rate.
- Government intervention will remain a wild card to forecasting the future GDP growth rate. With the federal government trying to "change" many political and economic policies such as health care reform, a climate change bill, $8,000 tax credit for first time home buyers, cash for caulkers, and the future level of tax rates, etc., these future outcomes will dramatically alter the level of economic activity.
- The unemployment level will remain high and this will have a number of economic consequences, including implications for the commercial real estate sector as it puts downward pressure on occupancies and rents.
- Bank lending standards will remain extremely tight.
- State and local government finances will not be turning around soon resulting in a disproportionate share of downgrades compared to upgrades.
- An abundance of Treasury supply could cause ten-year Treasury bond yields to reach 4.25% by the end of the second quarter. Should this occur, the negative economic impact on the market will be swift and as a result interest rates should be moving back to a range of the low to mid 3's by year end.
- Should Treasury yields rise during the early part of 2010 we anticipate that the increase in tax-free rates should be more modest.

## Bought But Not Paid For

It is fair to say that we have been surprised by the rapid return in positive GDP and the extent of recovery of world equity markets.  As we mentioned above, there are many positive economic measurements that have demonstrably improved.  The equity rally alone has helped restore significant wealth or at least has partially offset home price erosion. So, while the improvement is real and measurable, we should examine how it was achieved.  After witnessing the Government print and spend trillions of dollars, we achieved a Q3 GDP of +2.8%.  "Experts" believe that roughly 2% or as much as 70% of this growth was due to cash for clunkers and the $8,000 credits for first time home buyers.
Any balanced examination must scrutinize the unprecedented steps that have been taken to produce the above mentioned growth:

- Fed maintaining a zero interest rate policy during 2009.
- Buying close to two trillion of mortgage and Government debt obligations (quantitative easing).
- The countless number of Government programs that have increased the national debt to a level both unimaginable and unsustainable.

The spark and the source of fuel driving growth is important since our nation's track record with using unpaid dollars to buy a higher level of GDP has been anything but stellar.  We can all recall that following the tragic events of 9/11, Fed Chairman Greenspan supplied the marketplace with "free money" to unclog an economy that was virtually at a standstill.  Today, are we again repeating mistakes made in the past as the Government attempts to fix more problems by blowing additional but unknown bubbles?  Said another way, sometimes market participants only look at the positives of stronger growth, thinking there is such a thing as a "free lunch".  This group is squarely focused on only positive news items such as:

- Retail sales are improving
- Factory orders are expanding
- Pace of job losses are slowing
- Vehicle sales are strengthening
- Pending home sales are rebounding
- Equity markets are surging

Although we have no history of $15 trillion debt, we do know that those who lent us the money would most certainly like us to pay it back.  This should likely create an unprecedented burden on the American people.  The Fed has created a "pool-sized" punch bowl and no one knows when they will stop filling it, or when they will remove it, and what the ultimate repercussions will be.  At RSW, we believe that there is a childhood experience that many of us have shared that is analogous to our present circumstances. These extraordinary measures are our economic training wheels and Washington has its hand firmly on the seat.  However, only time will tell if we can truly ride on our own when Washington removes their supporting hand and the training wheels are unscrewed.

Lastly, another old but hot debate is whether surging inflation is right around the corner, even though deflation remains today's phenomena.  As we have all learned from the Japanese phenomenon, once asset and credit bubbles burst, the effects of deflation tend to linger, not evaporate. In summary, with the current weak economic conditions and a financial system that is likely to continue to de-lever, it is our view that the Fed's primary policy goal is to prevent deflation.

## Municipal Bond Perspective

"The more things change the more they stay the same." As we look ahead to 2010, we do with much of the same beliefs that we held twelve months ago. Although the financial health of Corporate America has improved markedly, the budgets of many state and local governments continue to be impaired. As the economy drifts between slow growth and slower growth, many municipalities will continue to experience cash shortfalls.

Analogous to 2009, this should put further downward pressure on the credit ratings of many municipal bond issuers. With that said, issuer defaults should continue to be as scarce as the Federal Government balancing its budget. A recent statement released by Standard and Poor's (S&P) distills this thought quite well: "Although we expect additional Chapter 9-related stories to emerge as governments continue to feel the lagging effects of the economic downturn, we believe that these stories relate to a small minority of governments."

In 2010, should investors expect the same robust returns witnessed over the last twelve months? At RSW, we believe that just as 2008 was an anomaly where the municipal indices lost value, so too were the returns recorded this year. In contrast, some pundits are "pounding the table" about the "cheapness" of the tax-free market given the likely rise of future tax rates. Although we agree that tax rates are likely to rise considerably, we believe that some additional credit downgrades will absorb much of that benefit. Therefore, we believe that the tax-free market is close to being fairly valued relative to our Treasury brethren.

Lastly, some state and local governments may put-off making the politically unpopular decision of slashing budget expenditures or raising taxes. However, the apparent self-breaking mechanism in these instances is the Press. As news surfaces about "an issuer in crisis," government officials miraculously seem to implement some of the difficult but necessary measures. We must be mindful that all states except Vermont (another state we choose not to extend a loan) must balance their budget annually. As we all know too well, this does not mean that the legislative process will be uneventful, and painless.

We wish everyone the best of health and success in the New Year.

Robert S. Waas
Managing Member