2011 – "Half a League Onward"?

As 2010 draws to a close, the Treasury bond market is again "selling-off" just as it did at this time last year. The key difference this time – currently, municipal bond prices are falling precipitously as well. Will this trend continue? Will 2011 be the year of skyrocketing interest rates? Will credit downgrades continue to be a bigger story than defaults? Will inflation finally rear its ugly head? How about deflation? Before we offer our 2011 prognostications for these and other topics, let's keep with tradition and first look into the rearview mirror, and compare how our 2010 economic and financial forecasts matched with reality.

A Year In Review

What we got right!

- Growth will be positive in 2010, but will still remain below trend.
- Given 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.
- Bank lending standards will remain extremely tight.
- An abundance of Treasury supply could cause UST 10-year bond yields to reach 4.25% by the end of the second quarter (10-year US Treasury bond yields reached 4% in May 2010), and are closing 2010 in the low-to-mid-three's.
- Should Treasury yields rise during the early part of 2010, we anticipate that the increase in tax-free rates should be more modest (tax-free yields actually declined).
- State and local government finances will not be turning around soon, resulting in a disproportionate share of downgrades compared to upgrades.

What we got wrong!

- 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.

Before we "cut to the chase" and list our 2011 forecasts, it is equally important for us to outline the whys and wherefores of these predictions. To this end, we will highlight some less talked about concepts, that may have a stealth-like influence on the effectiveness of monetary and fiscal policies, and ultimately the growth path of our economy. As we push ahead, it is important to remember that while the discussion relates to economics, solutions to these concepts relate to politics.

Should The Question Be: How Much Growth or Growth at What Price?

To begin, Ben Bernanke's goal with respect to this latest round of quantitative easing (QE2) is to suppress longer-maturity UST bond yields, and inflate the price of riskier assets. The working hypothesis anticipates that as asset prices rise, so too will confidence and risk taking. The Federal Reserve's expectation is that this renewed confidence will spur corporations and entrepreneurs to feel more assured about their economic prospects and, in turn, are more likely to expand, start new businesses, and thus hire employees.

However the Fed's monetary policy is finally judged, our domestic economy has developed monstrous fiscal and economic imbalances that won't be corrected by GE stock reaching to 22, or Bank of America reaching to 16. A key reason why this asset inflation strategy is flawed rests on the dispersion of wealth in the United States. Roughly 83% of the financial wealth (total assets minus the value of your home) is held by only 10% of the populace. With the vast majority of the financial wealth concentrated in so few hands, it is rather predictable that equity market movements do not meaningfully impact consumer spending. In contrast, however, in a study conducted by Robert Shiller (Yale University), he concluded that there is a strong link between variations in home prices and the level of individual consumption. With this in mind, it is interesting to note that the Fed freely admits that their Quantitative Easing program will provide little help in boosting home prices in the beleaguered housing sector. As an aside -- none of this is meant to belittle Bernanke's efforts, we just don't believe the Fed has the necessary medicine in its bag to cure this strain of flu.

In fact, it is possible that QE2 may actually impede future economic activity. In recent weeks, Treasury market participants have become concerned about the current inflation outlook, and have sold bonds aggressively. With yields spiking, an additional headwind is being created in interest rate sensitive areas, namely housing. Additionally, commodity prices have escalated in a number of areas such as food and energy, which is "forcing" consumers to spend additional monies on necessities, leaving fewer dollars available for discretionary spending.

There is one final thought that may be the guiding principal of how we look at the financial world. First, we would like to be on record that we share the widely held view that the private sector around the world is in noticeably better shape than it was at the height of the crisis. It is even fair to say that growth has surprised us to the upside, and may even improve with the passage of the tax compromise. But what has guided our thinking virtually from the beginning of this crisis, is our perspective on the destructive nature of debt. What is most often referred to as the financial crisis, or the housing bubble, is at its root, a debt crisis. If we at RSW, at times, seem too negative on the economy, it is because we are concerned with how our growth is obtained. Whether growth is 2% or 3% seems less important, ultimately, than the fact that we have added to our mountain of debt to achieve that growth. Developed nations around the world have dramatically increased their credit obligations, and many have demeaned their balance sheets with similar variations of Quantitative Easing.

We ask ourselves why the current period is any different than that seemingly benign period of 2004 to 2006? Hereto, growth was being distorted by an increase in private debt. Certainly, we can all remember the vast amount of debt that was racked-up by corporations, as they used the proceeds of bond issuance to buy back the stock of their own companies. We know this makes us sound like Mr. Grinch, or worse yet, like bond guys who are always pessimistic (“bond ghouls”), but history has to teach us something. Perhaps, we should not be concerned only about how much growth, but instead, growth at what price?

We must be mindful that recessions brought on by overproduction or some other supply-to-demand imbalances are inherently different than a financially caused recession. Professor Kenneth Rogoff, and Carmen Reinhart, in their exhaustive work “This Time is Different: Eight Centuries of Financial Folly” is a great read for anyone involved in the financial markets. The authors studied the financial path of 66 countries after a financial crisis and drew important conclusions from their work. Yes, they explained why all deep financial crisis are different, but more importantly, they concluded that they are often followed by sovereign debt crisis.

We hope that our reluctance to declare economic victory should not be viewed unpatriotically. It comes from one undeniable fact: the world has been rescued from the abyss of financial chaos by an enormous increase in public debt, and by unprecedented swelling of the Fed’s balance sheet (i.e. printing money). It is the servicing (principal and interest payments) of this debt that should only serve to act as an anchor on domestic as well as global growth prospects in 2011.

A Year In Preview

2011 Forecasts

- No “V”-shaped bounce for the economy, as GDP growth continues at a sub-par pace.
- Deflation in force.
- Ten year Treasury yields could reach 3.90% before falling back to the 3% range. As we have witnessed on

many occasions, there appears to be "self-braking" mechanisms in place that should prevent yields from rising above this level. This economy is leveraged, and very dependent on a low interest rate environment. Any interest rate shocks could cause a severe downturn in the overall economy, and in particular, cause erosion in home prices, with similar price action in the equity markets.

- Municipal defaults will remain scarce, especially amongst the higher quality borrowers.
- State and local Governments should continue to struggle as budgetary issues continue unabated. As a result, more municipal issuers could have their debt downgraded compared with upgraded.
- The ratio of 10-year "AAA" rated tax-exempt to Treasury bond yields should decline to approximately 85%, from 95%.

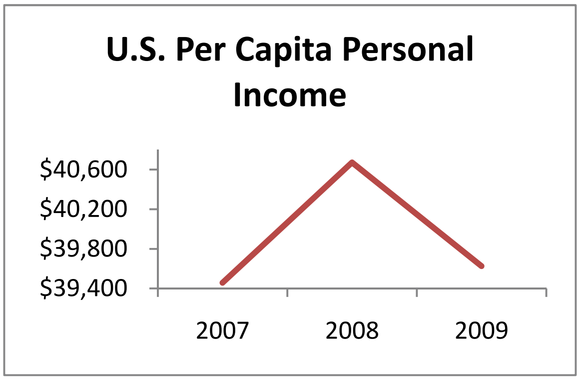
End of Year 2010 Update (Dec 15, 2010):

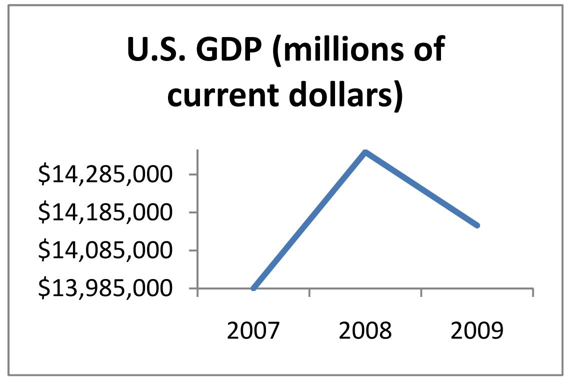
Since early November, the municipal bond market has been punished, as the level of new-issue supply has dwarfed investor demand. In addition to the relatively high level of new issuance this time of year, issuers have piled into the market to "beat" the expiration of the Build America Bond program. As it became more apparent that the program would not be extended beyond this year, another wave of new-issuance was priced in the market just at a time when investor demand has been seasonally weak. These elements coupled with rising Treasury bond yields served to cause a rapid increase in tax-exempt interest rates.

In our 11/15/10 Intra-quarterly commentary we said: "Given the current and anticipated supply-to-demand imbalance, it seems likely that the municipal market will continue to experience further price pressure into mid-December." While there can be no doubt that we did not anticipate the extent to which yields would shoot higher, our premise remains the same. Beginning next week, we are entering a period dubbed the "January effect" a time when historically, investor demand dwarfs new issue supply. Just as the tax-exempt new issue calendar is poised to slow to a trickle, investor demand should rise significantly, with investors becoming flush with cash due to an elevated level of maturing securities, bond calls, and coupon payments. These forces have traditionally resulted in meaningfully higher tax-exempt bond prices.

Battle Scarred But Not Charred

If a picture is worth a thousand words, then the following two graphs get right to the point of depicting the velocity and severity of the recent great recession. The steepness of the decline in personal income and GDP permeated all aspects of the nation. The nation's public finances have been severely strained since the recession commenced in December 2007, and continue to be so. A recovery to prerecession revenue levels for the states is not projected until at least 2013 to 2014. Nevertheless, while municipal bond credits, on a sector-by-sector basis, continue to have rating agency negative outlooks, as a whole they have performed well reflecting their status as the strongest asset class – second only to U.S. Treasuries.





Many municipal issuers, however, have come “unglued”, with few prospects and uncertain strategies for relatively short-term solutions to achieve financial structural balance. California, Illinois and Nevada grabbed most of these recent headlines, and will continue to do so going forward. It was not surprising to us to note that California and Illinois’ taxable Build America Bond aggregate issuance of $47 billion, since program inception in 2009, accounted for roughly 30% of all taxable BAB issuance. The absence of these stressed credits from the tax-exempt market helped to support tax-exempt bond valuations and kept credit spreads from widening further. Since it seems certain that the BAB program will not be extended, the resurgence of tax-exempt issuance from these weaker credits could induce incrementally higher yields and wider credit spreads going forward. We believe, however, that much of the impact will be felt in the longer maturity ranges.

To some degree, the municipal headlines could have been even worse during the course of 2010. Both Moody’s and Fitch implemented their previously postponed “recalibration” of the municipal rating scale to the corporate rating scale. This resulted in large scale higher ratings, not to be considered upgrades, for most municipal issuers, including virtually all tax- backed and essential service revenue bonds. Without this recalibration, many issuers would have flirted with lower investment grade ratings conceivably including Illinois and California.

Credit Downgrades Dominate 2010

- Moody's ratio of credit upgrades to downgrades during the 3rd quarter of 2011 was only 0.5-to-1, one of the lowest ratios in at least five years, and importantly, significantly worse than the 1.1-to-1 ratio exhibited during the first quarter of 2003 as the nation recovered from the previous recession.
- 71% of the par value of all Moody's municipal downgrades were concentrated in the states of Illinois, California, and New York, with Illinois by itself accounting for 41% of the total.

Some Good News- The Bleeding Stops

- State tax revenues for the third quarter of 2010, according to preliminary data, increased by 3.9% from the same period a year earlier. This was the third consecutive quarter of same period year-over-year growth.
- 41 states had non-farm payroll over-the-month employment gains in October 2010. The largest increases were in Texas (+47,000), New York (+40,600), California (+38,900) and Michigan (+19,000).

2011 Should Bring:

- More headline risk for many major bond issuers.
- Nascent economic recovery with municipal bonds still confronting negative credit factors.
- More credit downgrades as government finances continue to be stressed by social service demands, pension liabilities, lower assessed valuations, and improving but still lagging revenues.
- Continued anti-tax sentiment.
- Discussions to end the tax exempt status of municipal bonds as part of deficit reduction.

Creditworthiness is Proven in Bad Times Not Good Times

- While we expect more credit dislocations during the course of the upcoming year, municipals, as an asset class, will continue to provide safety and income.
- As the preceding charts demonstrate, the municipal asset class has survived the most aggressive and encompassing recession since 1929.
- Nevertheless, we will continue to adhere to our principled and disciplined investment philosophy in 2011.
- Our philosophy of adhering to a strong credit discipline, without "chasing yield," has served clients well during this downturn.
- We will continue to seek bonds with good structures that maximize cash flow without undo credit or interest rate risk.

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