2012 – Mind the Left Hand Drive

With investors around the world experiencing periods of nearly unparalleled financial market turmoil, long standing assumptions that were once core beliefs are now being called into question. Chief among these questions is whether government bonds are truly iron clad. Globally, investors have little confidence that political leaders have the capacity or will to tackle their problems. As a result of this lack of assurance, world markets are trading in a schizoid manner, with vast pools of monies fleeing riskier asset classes. RSW Investments, LLC and our clients have been the beneficiary of this re-directed investment activity, as monies have been chasing the relative safety of U.S. Treasury and municipal bonds during 2011.

Before peering into our crystal ball and cataloging our projections for 2012, we will begin with our tradition of looking back at the past and score our prognostications.

2011: A Year in Review

What we got right!

- "No 'V shaped' bounce as many pundits expect, as growth continues at a sub-par rate".
- "Ten year Treasury yields could reach 3.90% before falling back to the 3% range." Yields did rise and peak at 3.75%. With that said, market interest rates penetrated the low level of our expectations.
- "Municipal bond defaults will remain scarce, especially among 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%." During May 2011, this ratio dipped to 82%.

What we got wrong!

- "Deflation in force." We are wrestling with where to put this one: "right" or "wrong" as the theme is currently still playing out (classic debt deflation that is impacting economic growth levels and long term inflation prospects). However, the consumer price index did rise during the year.

As we look at the landscape (economic, investment, social, or otherwise) for 2012, we do so with trepidation. It appears that we are "dancing on the head of a pin" surrounded by important events, challenges, and decisions that must be skillfully managed by government officials (both foreign and domestic), or the course of our nation and worldwide economies could be negatively impacted.

We can't recall a time when so much was at stake:

- Burgeoning budget deficits
- 2012 U.S. Presidential elections
- Record low levels of trust in elected officials
- Super committee
- European crisis
- About 1 out of 7 Americans on food stamps
- Falling home prices
- Sub-par economic activity
- Deflation
- Global tensions
- Eroding social mood
- Quantitative Easing, "Twisting", etc.

Castor Oil or Milk of Magnesia?

After years of governments living beyond their means, debt has been piling up on sovereign balance sheets. It appears that there was either an outright neglect for the nasty consequences that might occur, or a hope/belief that the "debt" problem could be cured by "growing your way out". While there remains a possibility that robust growth can serve to "bail out" some sovereign nations, in the case of European entities, this outcome is being complicated by the financial markets. A willingness to lend these indebted nations additional funds has been sharply compromised. The actions taken by market participants are in fact saying: "Take a hike; your credit cards are maxed out". Given this backdrop, we find ourselves in the midst of a global debt crisis that is causing political policies to shift rapidly. To tackle their debt load, and effectively "de-lever", the world is rapidly evolving toward behavior that can best be characterized by "tight fiscal policy and loose monetary policy", a departure from the previous behavior of "loose fiscal policy, and tight monetary policy".

In essence, nations are "squaring off" against an opponent that is different than the one that led to the 2008 recession. That unhappy episode was triggered by a financial crisis, sparked by plunging valuations in private sector securitized assets such as Collateralized Mortgage Obligations (CMO's), Collateralized Bond Obligations (CBO's), Collateralized Loan Obligations (CLO's) etc. As the prices of these "assets" sunk, bank solvency eroded, and the health of the entire financial system was brought into question. Today, however, the opponent is not only that of private debt, but public debt. More specifically, today's predicament is the result of banks' exposure to declining valuations of public-sector-issued European Sovereign debt. Investors previously assumed that sovereign entities could always "print" their way out of any crisis, thus protecting the principal amount of sovereign debt issues. This may be flawed logic when applied to the Euro however, as the current issues are centered around a single currency financial system in which the fiscally conservative European Central Bank (ECB) administers the monetary policy of the 17 Euro-zone member states. As such, the Europeans' lack the ability to administer coordinated monetary and fiscal action to combat the debt crises further complicates the prospect for a long-term resolution. In other words, here in the U.S., we know how difficult it is for the House and Senate to agree on budgetary issues, let alone 17 member countries agreeing on key policies.

We also need to understand that the problems the world is facing today have morphed and broadened since 2008 because of the sovereign debt crisis. Remember, as the banks were busily shedding their exposure to traditional loans, they significantly increased their exposure to the highest quality loans, i.e. sovereign debt. Now, the sovereign debt exposure is in essence "polluting" bank balance sheets. So in effect, we are now witnessing both: a weakened financial health of the banks, and sovereign nations. Complicating the issue is that, unlike 2008, governments lack the same will, or resources to provide any assistance.

In some ways, the world markets remind us of an American tourist in London who leans into the street looking in the wrong direction to see if the bus is coming, and then gets hit in the back of the head by a taxi. All eyes are now fixed on Europe to see if they have a plan to save themselves, and more importantly, to see if they have the political will to actually implement that plan. In the meantime, markets lurch between believing that the end of the western world is near, to convincing themselves that European Summits produce silver bullets. As money managers, we need to avoid investing by headlines and face up to an unpleasant fact: success in saving Europe means a prolonged recession, slow growth, painful austerity, social unrest, and remedying an unsustainable debt structure in several Euro Zone nations.

In RSW's second quarter commentary we asked: "Is there enough lipstick for those PIIGS (Portugal, Italy, Ireland, Greece, and Spain)?" Today, we ask: is there enough mortar for those BRICS (Brazil, Russia, India, China)? As much as great attention should be paid to a crippled Europe, there is an under-reported story happening in the "locomotive of global growth", the "BRIC" countries. While the rest of the world would love to have India or

China's rate of economic growth, there is a clear and pronounced deceleration currently underway that also includes Brazil. China's growth rate was 10%, and is now closer to 8%. India's growth rate has declined from 7.70% to 6.90%. and Brazil's rate of growth is closer to that of the USA and currently stands at 2.10%.

Furthermore, there does appear to be a growing concern that there is a housing bubble that could be bursting in China that may add to "tail risk" (left field event). We mention these things because at times headlines can divert your attention from broader, more subtle dangers. A slowdown among demand in developed countries has to ultimately have a negative effect on the exporting countries (BRICS). While it is certainly true that for periods of time markets can "decouple" from each other, there is no doubt that global economic "connectivity" is, and will continue to be, alive and well.

So where does all of this take us at RSW? Unlike the American tourist, we don't want to be caught looking the wrong way; i.e. only at the headlines. We believe there will continue to be periods of fear followed by periods of relative euphoria. Looking ahead, we do not see our central tenant -- that has been in force for the last several years -- changing. Namely, there are powerful deflationary headwinds that will not be offset by a European Summit, or by the European Central Bank (ECB) buying Italian bonds. The underlying disease of worldwide structural unemployment, declining middle class wages, growing social unrest, and the unsustainable debt burden of most of the developed world, may collectively stifle the level of future economic activity.

In short, world governments are left with only a few options to preserve themselves. Unfortunately, none of them will be easy to implement, or taste very good **… Castor Oil, Or Milk of Magnesia?**

2012: A Year in preview

Forecasts:

- Largely Unchanged from 2011.
- U.S. Economic activity, as measured by GDP will grow in the zero to two percent range.
- 10 year U.S. Treasury bond yields could reach 3%, should a spike occur, quickly settling back down to around 2%.
- Deflation remains in force.
- Municipal defaults will remain scarce, especially among the higher quality borrowers.
- 10-year municipal bond yields, which are currently valued at over 100% of Treasury bonds, should decline to below 85%.

Municipal Bond Perspective

"It Is a Tale … Full of Sound and Fury; Signifying Nothing"

2011 Remembered for What Didn't Happen

This quote from Shakespeare's Macbeth describes the media induced frenzy that accompanied the Meredith Whitney exaggerated claim putting the number of municipal defaults for 2011 somewhere between 50 and 100 with a par value in the $100 billion range. Through the third quarter of 2011, there have only been 3 small rated municipal defaults, among Standard & Poor's 17,000 rated municipal issues. These have occurred only in health care and housing issues, sectors typically not consistent with RSW investment criteria.

"Just the facts Ma'am, nothing but the facts"

- According to Moody's, over the 30-year period ending in 2009, there were only 54 rated municipal defaults, compared to more than 1,700 corporate defaults. Approximately 80% of the municipal defaults were in the healthcare and housing sectors. Typically, recovery in the event of a monetary default, as opposed to a technical or covenant violation, has been approximately 85 cents on the dollar.

What about municipal bankruptcies? They are rare and few in number.

- ***Harrisburg, Pennsylvania and Jefferson County, Alabama are self-inflicted wounds and not harbingers of future bankruptcies to come.***
  - Both situations were essentially man-made: that is a combination of poor management decisions, and in the case of Jefferson County, corruption and fraud.
  - Harrisburg's bankruptcy petition was rejected by the court while Jefferson County's is still under consideration.
  - Municipal bankruptcy filings are rare, and are often the last resort to prior negotiations, and generally used by only small municipalities and special tax districts.
  - Municipalities in only 11 states have specific authorization allowing for filings, 13 other states require state approval.
  - Judges, more often than not, reject municipal bankruptcy filings.

- In a municipal bankruptcy, debt that is secured by a pledged revenue stream still gets paid from pledged funds and cannot be interfered with or impaired.
- There were only 6 municipal bankruptcy filings in 2010 and 4 through the first half of 2011.

Creditworthiness is Proven in Bad Times Not Good Times

- The following table depicts the enormity of the length and breadth of the recent recession when compared to the most recent downturns. It also helps to explain the relative weakness of the nascent recovery in the two and a half years since the recession was "officially" declared over. The job losses, especially in the goods producing and construction sectors, were significantly higher, and in most cases, by a relatively large multiple.
- "Economic recovery" has a long way to go, as the unemployment rate remains high with a virtually unprecedented duration.

Percent Change in Employment during Recessions, 1973-2010, seasonally adjusted

	Nov. 1973– Mar. 1975 (16 months)	Jan. 1980– July 1980 (6 months)	July 1981– Nov. 1982 (16 months)	July 1990– Mar. 1991 (8 months)	Mar. 2001– Nov. 2001 (8 months)	Dec. 2007– June 2009 (18 months)
Total Private	-3.1	–1.6	–3.5	–1.3	–1.8	–6.6
Goods Producing	-10.3	-5.0	-10.6	-4.1	-4.9	-16.2
Construction	-14.3	-5.9	-8.2	-7.5	-1.1	-19.8

Source – Bureau of Labor Statistics

- Despite the "great recession" and tepid recovery, 50% of Standard & Poor's 17,000+ municipal ratings are "A", and another 37% are rated "AA".

High Grade Municipals Have Survived The Most Aggressive And Encompassing Recession Since 1929, Two Years Of Anemic "Recovery" And Doomsday Headlines Regarding Default And Bankruptcy.

Looking Ahead to 2012

- While states are showing, on average, increases in tax revenues, they still remain below pre-recession levels.
- Local general obligation bonds dependent on property taxes in many regions will be subject to downward credit pressures.
- Pension reform will continue to find support.
- Issuers that have not adjusted to the finality of federal stimulus funding will be subject to rating pressures.
- Social service and Medicaid expenditures will continue to persist.
- Cutbacks in federal spending as part of deficit reduction can negatively impact issuers.
- A potential downgrade of U.S. Treasury's following S&P by Moody's or Fitch would lead to another downgrade of pre-refunded municipals and bonds backed by federal monies.

No different than 2011, RSW will stay the course adhering to a strong credit discipline seeking bonds that maximize cash flow while minimizing credit and interest rate risk.

Robert S. Waas Managing Member	Robert K. Coates Senior Portfolio Manager	Matthew T. Werner Portfolio Manager	Mark J. Tenenhaus Director of Municipal Research	John A. Carlson Director of Business Development	Marites A. Vidal Data Analyst	Randy J. Fox Operations Associate	Brian E. Pawl Operations Associate