RSW INVESTMENTS

Telling Noah About the Flood: 11 / 12 / 2009

As we entered 2009, we strongly believed that the financial condition of state and local governments would continue to be under enormous pressure. In response, we tightened our credit quality standards and avoided those sectors of the municipal market that have traditionally been the most economically sensitive (i.e. multi-family housing, regional airports etc). As anticipated, the storm of budgetary red ink rose and can be directly attributed to four quarters of negative GDP growth (Q3 2009 the GDP grew at 3.50%). Below are some headlines detailing the current state of the States:

- For the fiscal year ending June 2009 State tax revenues declined by 8.2%
- State tax collections in the second quarter of 2009 declined by 16.6%
- Forty-nine States experienced a shortfall in revenue during the second quarter
- Income tax was down by 27.5%
- Sales tax collection declined by 9.50%
- Corporate income tax fell by 2.90%
- Unfunded pension obligations continue their march higher

With the financial health of state and local governments coming under increased pressure, "pundits" are once again predicting the end of the world or at a minimum, an apocalypse. With unemployment rising and related tax receipts from income and sales coming-up short, many municipalities have already begun the process of making the difficult choices. Just like so many businesses, state and local governments have been realigning their cost structure to the new reality. This does not mean however, that the process won't be painful. There is much work to be done; the rate of unemployment continues to rise, and some state legislators lack the political will to implement the necessary deep budget cuts.

In this challenging environment, we again reiterate our stance that credit rating downgrades of municipal issuers will continue to occur at an above average pace. With that said, as we have communicated quite often, there is a chasm between a downgrade/cash shortfall and a default. These fears do not take into consideration the nature of the municipal credits themselves, and instead serve to paint the market with a broad brush. For instance, commentators seem to be making an erroneous connection between a decline in revenue and bondholders not getting paid. Specifically, with each decline in sales and personal income tax the budget deficit expands, the municipality is strapped for cash, and so they infer that a default must be imminent. In other words, behind every negative article describing lower sources of revenue does not lie a default. It's simply a "wake-up call" for that issuer to get their financial house in order. A current example of this is the financial hole that the state of New York now finds itself. We believe what comes next is a series of frightening articles detailing the precarious financial position. What should be next is a series of revenue enhancers and budget cuts which will be necessary for them to meet their constitutional obligations to balance the budget. Sometimes, only when lawmakers are staring into the financial abyss do they make the very difficult decisions. Furthermore, the Obama Administration shows great resolve to maintain the financial health of state and local governments. In fact, we believe that the Federal Government will continue to provide financial aid even after the monies from the Stimulus package are expended at the end of 2010.

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RSW never wants to be viewed as being complacent about the rising financial pressures that are mounting in the tax-exempt asset class. But neither do we wish to contribute to the common overreaction that a spike in municipal defaults is the inevitable outcome of these weakened fiscal positions. We conclude by reiterating RSW's thoughts from the 2009 investment outlook (published in December 2008) "While it is true that the headlines about state budget deficits will be painful, and the political horse trading to close the gap excruciating, states (except Vermont) must balance their budgets annually. Investors should soon become attuned to the fact that a budgetary crisis is not synonymous with an inability to pay principal and interest."

Just as Noah did, we know the rains are coming, but we believe our credit selection remains the ark for our clients.

Sincerely,
Robert S. Waas

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