



Trying Times Indeed!

In the last several days we have been asked questions from FA's about our view of the financial crisis as well as our take on the municipal market against that backdrop. It prompted us to elaborate on our current views for the asset class, as well as the larger investment landscape. The problem at the core, in our view, is not liquidity, it's not the refusal to lend, it's not a loss of confidence or naked short selling. The problem is massive amounts of highly leveraged assets that continue to decline in value turning a liquidity problem into an insolvency problem. The other things listed above are effects and not the root cause. You don't lend when you are protecting your own balance sheet or when you don't trust the other side's balance sheet. Lehman didn't go out of business because of a lack of liquidity, but a lack of net worth. We start here because we believe that all of the liquidity facilities in the world (i.e. TAF, created a year ago) will not solve a negative net worth, so the FED provides liquidity to the dying and bails out those they think they must (FNMA, AIG). Until the government decides that they are going to create a massive pool of fresh capital (of an RTC type) that can be applied to sick institutions, the problem will remain. A series of events has been set in motion that has impacted all asset classes. There is an atmosphere of fear and panic that makes Treasury Bills and Notes the investment of choice. This mentality has existed for a while but has accelerated this week as the events of Lehman, AIG, and a money market fund breaking the buck "UNFULDED". With the level of fear extremely elevated, there are Treasury's and then there is everything else.

This brings us to the municipal asset class. We have tried to be "out-front" in our assessment that there will be a period with above average downgrades and even a marginal increase in defaults. We also believe, as has been the case historically, that these defaults will largely reside in weaker credit quality issues, and especially bonds of health care issuers. As you are aware, we have made a concerted effort to purchase bonds that are high quality and steer clear of sectors that are historically more troublesome. With that said: why are Municipal bond yields continuing to climb while Treasury yields are declining?

As we outlined in a brief commentary yesterday, the tax-exempt market is suffering from the same bout of illiquidity as every other market that is not a direct US Government Obligation. We have been asked by several clients whether the sharp rise in municipal yields is a sign that confidence is being lost in the ability of municipal issuers to pay their principal and interest. For this answer, we need to look no further than the pricing of pre-refunded bonds, backed by US Treasury securities and carry a "AAA"-rating. Here too, yields have risen sharply even as Treasury yields plummeted. If market participants were only focused on credit concerns, then the pre-refunded bonds would be trading closer to Treasury's and only the lower rated bonds (AA-rated) would be at yields that are far in excess of Treasury securities.

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As always, in these times of stress, certain signs should become apparent (i.e. PIMCO shifting assets to tax-exempts) that opportunistic buyers are once again taking advantage of these anomalies. We will do our best to keep you up.

Sincerely,
Robert S. Waas
Managing Member

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