



WASMER, SCHROEDER & COMPANY
INVESTMENT ADVISORS

From the Desk of the Chief
Investment Officer

2011



JULY 21, 2011

A TALE OF TWO MARKETS

Charles Dickens chose London and Paris in the setting of the French Revolution as the backdrop for his story *"A Tale of Two Cities,"* published in 1859, in which he uses the interesting technique of doubles to draw contrasts and convey the message that the world is one of multiple hidden patterns and connections.

Fast forward to present day, and witness the *"Tale of Two Markets,"* a story even Dickens might find not without its own revolutionary undertones. This time, and in this place – America, the revolutionary forces are, thankfully, of the non-violent variety, though we suspect the parallels, in keeping with Dickens' theme, are just as noteworthy as the differences.

What is government's purpose? Which services and functions should government provide to constituent voters and taxpayers, in what form of delivery and at what – or should I say, who's, cost?

Some forms of revolt are more problematic and disruptive than others, but as Thomas Jefferson said to James Madison, "A little rebellion now and then is a good thing." In this regard, the Great Recession has given rise to what may now be called the Great Debt Debate. As followers of this publication know, I have previously postulated – no doubt to some raising of eyebrows, that perhaps state government finances are collectively in better shape than our rich uncle named Sam. (See piece dated March 22, 2011 for details).

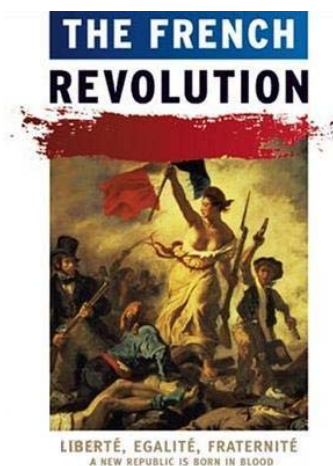
Since that idea was proposed, no less than all three of the National Recognized Statistical Rating Organizations (NRSROs) have warned Congress, Treasury, and the markets that the sustainability of the triple-A credit ratings for U.S. debt are not perpetual and are highly dependent on the House and Senate achieving an acceptable balance between what the Treasury calls "Receipts" and "Outlays" – the former being what most of us call taxes, and the latter the sum total of all disbursements departing the Treasury's possession.

But I digress.

My "tale," as it were, deals not so much with Uncle Sam directly, but rather the curiously dichotomous market for municipal bonds that has dominated the first half of 2011 – one that arguably becomes more worthy of a Dickens storyline each and every trading day. The municipal market double – like the characters in Dickens' novel, invokes images of a disconnect from reality.

Two Markets, One Reality

There is the municipal bond market as portrayed by some commentators – one characterized by massive municipal bond issue defaults, chaotic indiscriminate selling by individuals, dramatically rising yields on outstanding bonds and rolling, systemic, contagion-driven lack of access to the capital markets for issuers.





Then there is the other municipal bond market – the real one in which professional, experienced and informed investors participate every day. This is the municipal bond market in which the State of Utah recently sold general obligation debt with a yield of 2.7% in 10 years, and the city of Wilmington, NC sold \$3 million in general obligation debt with an average yield of about 1%¹. In both cases, the debt is fully-amortized – that is to say, repaid in full, over the term of the debt issuance. Wilmington’s bond issue will be completely retired in just six and one-half years, freeing up borrowing capacity for future needs.

In the real version of “Muniland,” when issuers borrow money, they actually pay it back. Generally, this is the most effective way for issuers to get investors to loan them money the next time they need it. Indeed, so far this year there has been a net pay-down, or drop, in the amount of outstanding municipal debt, thanks largely to the lack of new issuance, which is running about 50% of last year’s pace.

Why the disconnect between how the municipal market is portrayed and how it has actually been working? Similarities to Greece, the sub-prime mortgage disaster or even the debt ceiling debate and chronic deficits run by Uncle Sam are often implied or inferred, but such comparisons miss the fundamental, unmistakable distinguishing trait that is the cornerstone of public finance in America: State and local governments must, and therefore, do, balance their budgets.

Fiscal 2012 began in July – fitting as it were to coincide with the celebration of America’s own revolution some 235 years ago. The submission, debate, analysis and passing of the state budgets was marked by profound philosophical, social, political and economic challenges as shifts in the balance in state legislative and executive branch leadership followed the November 2010 elections and yet the states did what they’ve always managed to do: They made difficult choices and decisions. The municipal bond market recognizes these choices, and rewards or penalizes issuers in appropriate proportion to their various solution sets.

That is how the market is supposed to function.

So, the next time a client asks the question, “What is the condition of the municipal bond market,” perhaps we should remember the lessons of Charles Dickens, then reply, “Do you mean the real one?”

Disclaimer: The material provided is for informational purposes only and contains no investment advice or recommendations to buy or sell any specific securities. The statements contained herein are based upon the opinions of Wasmer, Schroeder & Company, Inc. (WSC), the data available at the time of the presentation which may be subject to change depending on current market conditions. This presentation does not purport to be a complete overview of the topic stated, nor is it intended to be a complete discussion or analysis of the topic or securities discussed. All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice. WSC does not accept any liability for any loss or damage arising out of the use of all or any part of this presentation. This report should not be regarded by recipients as a substitute for the exercise of their own judgment and may contain numerous assumptions. Different assumptions could result in materially different outcomes. Please contact Wasmer, Schroeder & Company for more complete information, including the implications and appropriateness of the strategy or securities discussed herein for any particular portfolio or client.

About the Firm: Wasmer, Schroeder & Company, Inc. (WSC) is an independent and employee-owned Florida S-Corp. WSC was incorporated in 1987 and registered as an investment advisor on July 29, 1988 with the U.S. Securities and Exchange Commission. The Firm’s corporate headquarters are in Naples, Florida, where the tax exempt Portfolio Management team, Client Services, Operations, IT, Accounting, Compliance, Marketing and Administration reside; our taxable Portfolio Management team is located in Cleveland, Ohio; and Client Relationship offices in Exton (Philadelphia area), Pennsylvania and Lake Oswego (Portland area), Oregon. Specializing in fixed income separate account portfolio management for high net worth individuals, wealth management groups and institutions, including foundations, endowments and retirement plans, WSC has \$3.94 billion in assets under management, as of 06/30/11. The Firm works with clients and their advisors to provide taxable and tax exempt fixed income portfolio solutions to meet their needs.

¹ Bloomberg.com