True North

There are many indicators used by governments and financial market participants to evaluate the direction in which the economy is heading. Pundits study traditional “tea leaves”, and cheer or sneer at the latest inflation or economic figures, but at RSW, we believe that these forecasters may be missing the forest by studying only the trees. In this quarter’s commentary, we lay out reasons why the traditional metrics that have served as our economic compass in the past may be going the way of Pluto.

We begin to build our case by reviewing the year 2008 (although many of us would rather not). In RSW’s Second Quarter 2008 Commentary we discussed the poor financial health of the U.S. consumer, and questioned whether or not they were “tapped out”? Specifically, we introduced the concept that consumers had likely entered a “deleveraging” cycle (i.e. prune debt rather than continue to borrow to spend) that could last for years to come. Our thesis rested on a foundation that slowing wage growth, and the rising cost of essentials (such as food and energy), would present steep challenges for individuals to continue meeting their pre-existing financial obligations.

Now, the million dollar question is why is this happening? And, does the Federal Reserve have the right prescription to cure what ails its economic patient?

Before answering these questions, we need to understand some of the larger forces that are acting as relentless headwinds to a broadening of the economic expansion. These include:

- Constant loss of jobs to overseas manufacturers
- Deleveraging by corporations and individuals
- Enormous disparity of wealth and income that is becoming more pronounced
- Education system in trouble and losing ground to overseas competition

While those in Washington are having a field day avoiding substantive discussions addressing these issues, an opinion or discussion of potential solutions remains political, and not the purpose of this musing. We will leave it to each reader to assign their own causes and solutions to any points raised. Our goal here is to underscore a long held belief at RSW that the problems and challenges that we face as a nation are structural in nature, and do not readily lend themselves to previously “normal” remedies.

Income Distribution

The latest employment report (released on April 1, 2011) held that wage gains for the last 12 month period increased by only 1.7%. This was the smallest year over year increase since the recession began. While many market participants are watching the rate of unemployment for clues regarding the economy's health, we remain focused on the earnings momentum of individuals, as we believe this data provides the "keystone" for a more accurate economic forecast. Perhaps equally as important, is the dispersion (or lack thereof) of income of domestic wage earners.

It is important to note that income for individuals in the top-third of wage earners in the country take home approximately $65,000. This contrasts with $1,600,000 for those in the top 0.1%. Said another way, due to the unevenness of earning power, during 2010, our nation added 600,000 millionaires, while 5,000,000 people were added to the food stamp program.

The more we expand the universe of those that are living on the "edge", the more that group is exposed to interest rate and commodity price shocks. With food, energy, healthcare, and college costs rising at an above-average pace, individuals' expenses are outpacing the growth of their income. This phenomena is particularly acute for the roughly one-half of all domestic households that are living on less than $46,000 annually. Simply put, we are running out of folks who can pay inflated prices for "stuff". Therefore, it seems highly unlikely to us that the domestic economy could experience strong lasting inflation shocks at a time when individuals are shedding credit, and their take-home pay isn't keeping up with their cost for necessities.

Concentration of Wealth

The same headwinds can be attributed to the unevenness of wealth creation. Specifically, the wealthy tend to derive income (profits) from stocks, while the middle class holds most of its net worth in housing. Unfortunately, for the "masses", the housing market remains "off its hinges". In this case, a rising economic sea is not lifting all boats equally, because many of the reasons for current wealth building (i.e., corporations cutting costs to boost profits) negatively impacts the working and middle class, who own very little stock. Therefore, even though the stock market rally is approaching a 100 percent increase from its March 2009 low, this benefit has only accrued to a disproportionately small share of the population.

The kinds of issues discussed above will not likely be fundamentally solved by efforts such as:

- Holding interest rates at zero
- Doubling down on a Treasury bond purchase program (or QE3)
- Enacting shovel unready stimulus plans
- Cash for almost anything (yes, that includes clunkers)

The structural dimension of U.S. economic problems leads us to conclude that it will take years before "balance" is restored to the "typical" economic cycle. It is even possible that the "balance" has become a more permanent state of imbalance. While saving the "patient" is key, we, as a nation, never seem to address the larger economic questions that may well determine our economic place in the future world. Structural unemployment, permanent shifting of jobs overseas, massive concentration of wealth, and stagnant wages for the masses are topics often used to score political points. Unfortunately, what seem to be missing from these discussions are proposals suggesting any real solutions to offset these ongoing structural imbalances.

Having said that, these comments should not be interpreted as an attempt by us at RSW to "slam" the efforts undertaken thus far or belittle the efforts on the part of Washington or the Federal Reserve. They are merely using the tools that they have at their disposal. However, we believe their tools are ineffective for the current task at hand.

The policies implemented thus far should only serve to inflate the prices of certain types of assets in the hope that the benefits will spread. In reality, this just leads to an illusion of prosperity that can make us think for a while that inflation is the coming problem. We are not claiming that the recent pick-up in inflation is illusionary, just that it is temporary. After all, how do you get $2.50 gasoline? The price goes to $5 first! As incomes stagnate and more discretionary income gets put into the gas tank, feeding the family, paying for soaring medical costs, and getting a second mortgage for college, the chances of embedded inflation disappear~~s~~. Higher inflation readings, set against the backdrop discussed above, should only serve to cement the next stage of a disinflationary/deflationary cycle. After all, the lifestyles of ever-increasing segments of the U.S. population are continuing to be impaired, as a larger share of wage-earner's take home pay is dedicated to paying for necessities, and is not available to increase discretionary purchases.

How can these phenomena and the forces behind their occurrence be anything but deflationary?

Is it a coincidence that the current level of GDP growth is only averaging less than half of other periods where the U.S. emerged from a recession?

Is it a coincidence that each time 10-year U.S. Treasury yields spike upward, the rate crests at lower levels?

Is it a coincidence that each time the level of inflation spurts upward, the rate peaks at lower levels?

We remain apprehensive that the damaging stealth socio-economic trends developing will not be cured by liquidity, massive debt, or even a "friendly" Federal Reserve. The environment has changed, and a new compass will ultimately be required to find our new "True North".

Municipal Market Recap

Stability returned to the municipal bond sector as "cooler heads" prevailed during the first quarter. There were a number of forces working in concert to arrest the market's decline that began in early November 2010. Namely: new issue supply dried up (January and February new issuance was the lowest in 11 years), investor angst about widespread and systematic defaults faded, Treasury bond yields firmed, and buying interest from institutional investors escalated. Serving to offset some of these positive developments, however, were individuals who continued to sell their mutual fund shares. Although the pace of redemptions from mutual funds slowed considerably from the pace reached late last year, this source of secondary market supply weighed on bond prices. Notwithstanding, tax-exempt bonds squeezed out a positive return, with the market (as measured by the Barclays Capital Municipal Bond Index) generating an overall total return of +0.51%.

Higher State Income Taxes Are Not a Singular Panacea for Budget Woes

While accurately forecasting the "big picture" requires relevant data, and a modern compass, sound municipal research also mandates that we consider the structural changes mentioned in the earlier portion of this musing.

There was a time when high relative wealth levels in a municipality enhanced the comfort level of a bond investor. However, times have changed. The recent recession was truly a perfect storm, in that it rocked all state and local government "boats" irrespective of their income levels. In fact, for most states that are overly dependent on revenues generated by taxes derived from the highest marginal tax brackets, the seas were a bit rougher. For example, a large portion of California's and New York's ongoing multi-billion dollar budget gaps can be directly attributed to declines in capital gains receipts from Silicon Valley and lower Wall Street bonuses.

Individual income taxes are the largest source of tax revenues collected by states -- except in those seven states where an income tax is not levied. Approximately $236.4 billion of such taxes were collected in 2010, a 4.5% decrease from 2009, despite the enactment of various permanent and "temporary" marginal income tax increases in the highest brackets. At the same time that the ability to pay for social services is declining, municipal government social benefit spending increased by 12.4% during this period.

This combination of falling receipts and increased expenditures offers some insight into the struggle that many municipalities have been, and will continue to be, battling. No different than the pressures on the federal government, state and local finances must also reorient themselves and find a new way that points True North.

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