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RSW's Q1 2016 Fixed Income Newsletter

The Unintended Consequence of the Well Intentioned

The Pension Predicament and Ramifications for Bond Holders

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The Unintended Consequence of the Well Intentioned (4/6/16)

Do we need to "save our economy from the guys who are trying to save our economy?"

Just when it appeared that the world's central bankers were fresh out of "stimulative ammunition" , they invented yet another technique to drive economic progress; NIRP.

Now, NIRP, the new stick of choice, threatens to confiscate your savings through a negative interest rate unless you spend or invest your cash.

While central bank negative interest rate policies are a sure sign of deflation, the growing pension crisis strangling "weaker" municipal borrowers is yet another tell.

Projected Puerto Rico bond defaults of $422 million on May 1st and $2 billion on July 1st are just around the corner.

Regardless of the ultimate resolution to the Puerto Rico crisis and the potential conflict between bondholders and pensioners, there should not be any significant ramifications for high credit grade municipal bonds.

In the series *Breaking Bad*, Walter White's goal can be characterized as a noble one - A chemistry teacher diagnosed with cancer, looking to create a "nest egg" for his family after he's gone. To secure his family's financial welfare, he resorts to cooking meth. As his scientifically formulated recipe spreads like wildfire throughout New Mexico, Walter becomes more and more obsessed with power. He starts to behave as callously as the criminals who employ him, resorting to coercion and murder to stay alive. In fact, in one of the episodes of *Breaking Bad*, Walter's wife Skyler summed up their predicament this way: "I need to save my family from the guy who is trying to save my family."

Over the years, we have certainly taken our fair share of swipes at the Federal Reserve and World's Central Banks. The goal of the "chiefs" of these institutions is certainly a noble one as they seek to renew the pace of economic activity in their jurisdictions. However, as they double down on failed policies are we entitled to ask if we need to "save our economy from the guys who are trying to save our economy?"

Since the onset of the financial crisis, RSW has driven the bus for those who believe that the various QEs have been of limited lasting economic value. It remains clear that, at a minimum, the transfer mechanism from low rates and elevated risk assets to the actual economy is broken.

For years, we have argued that structural headwinds are the reason why. Our view has been confirmed by a slowing pace of growth, despite the extraordinary policy efforts of the Fed which has produced unremarkable results. However, until now, we never suggested that these underwhelming results were partially caused by those same policies. Below, we have outlined four key reasons why we believe Fed policy is part of the problem and not a solution.

1. For nearly a decade, financial asset prices of all stripes have been boosted by the Federal Reserve's policies. As this rise in investable assets failed to stimulate the broad economy, many CEOs lost confidence that they can spark revenue growth by investing in their businesses. Therefore, in order to boost Earnings Per Share (EPS) they have engaged in short term activities, such as buying back company stock. These decisions can be reduced or increased rapidly, thereby providing CEOs with a high level of flexibility. This resultant risk aversion to invest in fixed assets creates a preference for shorter term commitments, i.e. financial assets, thereby forcing those prices higher.

2. In addition to what was said above, financial assets are also more liquid. In a crisis situation, capital equipment and other fixed assets cannot be readily converted into cash. In contrast financial assets, notwithstanding today's reduced level of liquidity, can be sold if the company is strapped for funds. Having come through 2008, today's CEOs know that illiquidity can be fatal. For example, let's look at the collapse in the price of oil. If you think that it's difficult to sell a bond that is issued on behalf of an oil company that is rated "B", try selling an oil platform.

3. The Federal Reserve's Quantitative Easing (QE) policy, if not by design, may reduce the level of volatility over the short run in the financial markets, but not in the prices of "hard" assets. Like in 2007, "macro" risk for hard (i.e., real estate) assets may be at a peak, just when market volatility is at a trough.

4. Intended or not, QE, or the Fed's Zero Interest Rate Policy (ZIRP), has a "calming effect", whereby financial assets are perceived to have a floor under them while real assets do not. As you may recall, this phenomenon was referred to as the "Bernanke Put", after our last Fed Chairman. Therefore, the actions of the central banks in essence boost the price of financial assets while having a negligible impact on the price of real assets.

Thank You Sir, May I Have Another!

Just when it appeared that the world's central bankers were fresh out of "stimulative ammunition", they invented yet another technique to drive economic progress; NIRP (Negative Interest Rate Policy). However, their solution to propel economic growth seems to hinge more on psychology than finance. In the field of psychology, behavioral modification is a technical sounding term but in its simplest form the method can be distilled into two parts: rewarding good behavior ("the carrot") and punishing bad behavior ("the stick"). For over 200 years, the carrot has always been synonymous with rate reductions, while the stick was equated with removing the carrot. Now NIRP, the new stick of choice, threatens to confiscate your savings through a negative interest rate unless you spend or invest your cash.

Who Got Another?

During January, the Bank of Japan implemented a negative interest rate policy as they announced an obligatory negative interest rate of -0.1 percent on any new excess reserves. It is the second central bank to do so as the European Central Bank (ECB) was the first to break the "zero bound" in June 2014. It is also important to note that the Swedish Central Bank (The Riksbank), has had an interest rate of -0.35% since the beginning of 2015. While Sweden's GDP is small compared to the other members of the "NIRP Club", the failure of the policy to spur inflation and growth is important to note because their society is essentially "cashless". With 95% of the retail sales executed with electronic payments, the alternative or ability to withdraw cash from the bank to escape negative interest rates is not feasible. In other words, if a NIRP policy doesn't succeed in a country where the savers are held captive to the bankers with the stick, it doesn't bode well to be successful anywhere.

Goal of the NIRP

The theoretical basis for NIRPs is straightforward. By lowering deposit rates below zero, central banks can charge private banks money (negative interest) for saving their excess reserves. In theory, this incentivizes banks to carry smaller reserve levels as they are encouraged to lend rather than save. Furthermore, the strategy hopes to encourage an increased pace of consumption that should ignite growth and inflation. In theory, the expansion of the money supply associated with this increased lending should promote currency depreciation, thereby providing domestic exporters with a competitive pricing advantage. For these reasons, NIRPs are essentially an extension of conventional interest rate policy. It is important to note however, that an attempt to manipulate local currency in this deflationary environment is a zero sum game, as it serves to spark a currency war that is just "unwinnable" (see RSW's 2015 Fixed Income Market Outlook entitled "Charge of the Bank Brigade").

The Harsh NIRP Reality

In reality, a NIRP policy signals that central banks are desperate, and leads to a loss of confidence by the citizenry. Furthermore, a policy so drastic "screams" that central banks are fighting strong deflationary forces. Just look what's happened in Japan: they tried negative interest rates and as the currency went up, the markets went down and the policy worked in reverse. In fact, the stock markets in Japan, Italy, and Sweden are all down over 20% from their 2015 peak. These declines tend to project what the public at large is facing: a scarcity of high paying jobs, building wage pressures, and downward pressure on employee benefits and resultant mounting level of sovereign debt.

While NIRPs haven't yet made their journey across the Atlantic, we at RSW believe that it is just a matter of time before the Federal Reserve joins the crowd and pushes short-term rates into negative territory. The monetary authorities are concocting their own brand of scientific formulated recipes and sending a signal that there is more to come. At the same time, they expect businesses to invest and consumers to borrow and spend, as a result of their noble deeds. It is no wonder that the transmission mechanism and these failed policies are broken. Perhaps we need to "save our economy from the guys trying to save our economy?"

Municipal Bond Commentary

The pension predicament and ramifications for bondholders

While central bank negative interest rate policies are a sure sign of deflation, the growing pension crisis strangling “weaker” municipal borrowers is yet another tell. As we have outlined in past commentaries, unfunded pension liabilities tend to mushroom quickly and solutions get harder to implement. The Puerto Rico debacle (described below) and the lack of political will in the Commonwealth and other jurisdictions to deal with this growing problem has sparked a number of debates about contract law. Specifically, who has a priority claim on a state’s available funds, the pension recipient or the bondholder? As the proverbial can has been kicked far enough, and the road leads to a cliff, the eventual outcome for troubled municipal issuers is likely to be pain.

What are the lessons of the Puerto Rico debacle and calamity for investors in municipal bonds?

Projected Puerto Rico bond defaults of $422 million on May 1st and $2 billion on July 1st are just around the corner. The municipal market is concerned that a proposal from the Obama administration to restructure Puerto Rico debt would make pensioners superior to the lien of bondholders. The Republican bill coming out of committee does not include this requirement, nor does it give the Commonwealth the right to declare bankruptcy which presently they do not have. Therefore we believe that if any congressional restructuring legislation was enacted, a provision giving pensioners an edge over bondholders would not be included.

It is also important to note that the adoption of any congressional legislation would be viewed unfavorably by the current Puerto Rican administration. Conceivably, this legislation could be subject to legal challenges on the basis that such an agreement would violate the relationship of the United States and Puerto Rico. In other words, this would render the legislation to be illegal as defined under the Commonwealth’s constitution.

Technically speaking

Furthermore, if we drill down to the Commonwealth's constitution and the security pledge as defined under the covenants to the general obligation bondholders, we find key words such as: *"irrevocably pledged', "prompt payment" and "first claim on available Commonwealth resources.*" Therefore any legislative or judicial ruling that would render pensioners in a superior lien to general obligation debt holders would be difficult to imagine.

Nevertheless, the Commonwealth has stopped putting aside funds for the next scheduled payment for general obligation supported debt due to liquidity issues.

Importantly, the last consideration is the **U.S. Supreme Court.** Despite two previous lower court rulings that essentially are supportive of Puerto Rican bondholders, the U.S. Supreme Court is questioning as to why Puerto Rican authorities do not have the ability to declare bankruptcy like the majority of mainland counterparts. With a default looming and a restructuring of all Puerto Rican debt (including general obligation debt) relatively imminent, notwithstanding legal challenges it still seems likely that pensioners will continue to receive timely and full payments (as long as the funds are there).

Takeaway: Warning signs should be taken seriously when they first appear.

Storm clouds continue to gather in other states as well. For example, Pennsylvania went more than 6 months without a budget, with a stalemate finally brokered without any substantive attempt to deal with growing pension liabilities. After two recent billion dollar plus tax increases, Connecticut is trying to balance the books for this year and still confronts a billion dollar gap for the fiscal year starting July 1.

Pension issues in Chicago and Illinois (is New Jersey next?) are not to be resolved without further hardship to taxpayers and bondholders. The deterioration in these credits is well known and will only prove to get worse.

There are no magic wands in the municipal market that can cure these issues.

Bottom line
Regardless of the ultimate resolution to the Puerto Rico crisis and the potential conflict between bondholders and pensioners there should not be any significant ramifications for high credit grade municipal bonds. Lastly, at RSW, we are seeking to invest in bonds that are considered to be "sleep at night issuers." Therefore, if we were join the ranks of determining where bondholders fall in the pecking order (ahead or behind pensioners), then we are selecting bonds that should be considered too risky for our client portfolios.

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