Will the Economy Wobble After the Training Wheels Are Removed?

Three months ago, although surprised by the robust economic activity, we felt very confident that the stronger data exhibited during that period would soon falter. We reasoned that the sturdy pace of growth was primarily buoyed by two forces that were not likely to be self sustaining. Namely, the government's level of deficit spending, and the buying spree exhibited by multi-national corporations. We witnessed an inventory rebuilding cycle, whereby companies realized that their low inventory levels were not sufficient for their ongoing business needs.

In particular, we were concerned that the strength was provided more by stimulus training wheels. Although some positive news has emerged (i.e. low interest rates, unemployment falling to 9.50%), a number of current economic indicators have signaled that the recovery is in a declining phase. These include:

- New home sales have plunged to the lowest level on record, following the expiration of the $8,000 tax credit for first time homebuyers.
- Banks repossessed a record number of U.S. homes in the second quarter, spiking 38% from the second quarter of last year.
- The United States GDP growth rate for the first quarter of 2010 was revised down to +2.7%, weaker than many expected.
- After rising for seven consecutive months, retail sales contracted during May and June.

Is There Enough Lipstick For Those PIIGS?

A key source of financial market volatility during the second quarter was driven by the unfolding events in the PIIG countries (Portugal, Italy, Ireland, Greece, and Spain). Just as countries once worried about the spread of swine flu, nations are now concerned about the contagion brought about by Europe's mounting debt problems, austerity measures being implemented to reduce the debt, and the impact to the region's economic activity.

Specifically, Greece grabbed most of the headlines as the full extent of its debt crisis came to light. As is typically the case, the market is the final judge and jury as it opines on the financial health of a borrower. In Greece's case, the verdict was: Guilty, of financial negligence.

As the level of the United States fiscal imbalances mount, citizens are becoming increasingly concerned about the similarities of the U.S. and Greece predicaments. We at RSW do not believe that we have to be "Greece" in every aspect, nor do we believe that default is the only bad outcome. We fear, as a base case, that the U.S. faces serious structural imbalances or headwinds that make chronic anemic growth a high probability. While the credit crisis was frightening, an extended period of low growth (i.e. 0 to 2%), combined with high unemployment, brings its own long term damage to our social structures and competitiveness in the world. These harsh realities are now magnified by the explosion of debt that we are piling up as a nation.

In so many ways the economic growth witnessed in the second half of 2009, and the first quarter/half of 2010 was analogous to the expansion of 2003 to 2007. Then, the growth was generated by an enormous expansion of private borrowing and leverage, while now, the Government has performed the same function. Our concern at RSW has always been and remains whether the hand-off from Government to the private sector could be executed smoothly. With the latest round of economic data pointing to a renewed slowdown, the hand-off is looking increasingly like a fumble. As the effects of massive government and Federal Reserve stimulus, and home and car buying credits sunset, we are left in the same spot from which we started: a lack of final demand on the part of the consumer.

Just as Greece sought solutions from all corners, short of consulting the Oracle of Delphi, we too are thrashing around searching for solutions. Last week the President called in our own Oracle, the oracle of Omaha, to offer suggestions on how to get the economy to grow and unemployment to shrink. However, we as a country must face some unabashed facts. It's not about oracles, or government make-work jobs. It's not about home-buyer tax credits, cash for clunkers, or the magic bullet of the "green energy jobs." None of this is meant as a political statement, but a frank assessment of our economic circumstances.

It is ultimately about getting spending, or more accurately debt, back in line with the people's ability to service it. The path that is chosen to accomplish this goal won't be easy nor will it taste very good. The path also won't, and perhaps shouldn't happen overnight, but eventually a way forward will be found. We understand that much of this sounds rather dire. However, if we continue to avoid making the difficult decisions required of us, than just as with Greece, inevitably, the markets will show us that the U.S. can also be found guilty of financial negligence.

Municipal Bond Perspective

All the negative news regarding the ominous fiscal dilemma of municipal governments, has had little impact on prices of high quality tax-exempt securities. There have been ratings downgrades and a few bond defaults, but no widespread disaster from the tax-backed and essential purpose / utility issuers in the municipal bond market. A strong tail wind for tax-free investors has been the declining level of new issue tax-exempt supply. With many issuers opting to raise funds in the taxable municipal bond arena (made possible under the Build America Bond Program), traditional tax-advantage issuance has been relatively light compared to robust individual demand for the asset class.

As we look ahead, there are competing forces pulling at the market prices of municipal bonds. On the positive side, tax-free income is expected to fetch a greater premium as the "Bush" tax cuts are expected to expire in 2011. However, offsetting this development is the continued budgetary challenges that many municipalities will experience in to next year.

The Start of a New Fiscal Year Brings Little Good News

Most state and municipal government's fiscal year 2011 commenced on July 1st. Budgets, to the extent they were enacted on time, remain strained. The weakness of the economic recovery, high unemployment, increasing demands for social services, unfunded and growing pension obligations and retiree health benefits still remain as major concerns two and one-half years after the recession began in December 2007. Despite billions of dollars of budget cuts and various tax increases, fiscal year 2011 is shaping up as extremely weak. For state governments, aggregate budget shortfalls are estimated to be approximately $120 billion, roughly 20% of aggregate budgets. It will probably get worse, as many "balanced budgets" (required by law) have faulty revenue assumptions, rely on extensions of federal stimulus funds that will be not be forthcoming, and include many non-recurring solutions. These issues and shortfalls will not abate over the near future. Federal stimulus funds directed to the states since 2009 were approximately $140 billion - an amount equal to roughly 35% of aggregate shortfalls. Various states and municipal entities remain better equipped to confront fiscal challenges. The governor of New Jersey enjoys broader executive powers over spending than the governors of many other large states. The challenges remain large, as the state's employment levels today are similar to levels last seen 10 years ago while the state's spending has grown exponentially. This is true of most states. States with significant stress include California (no budget), New York (no budget since the fiscal year ended in April), Nevada, Arizona and Illinois.

In this challenging environment, we remain judicious with our outlook, tempered by a disciplined approach to credit, structure and interest rate risk. This strategy has served clients well, and should continue to do so at a time of uncertain economic recovery and persistent credit strain.

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