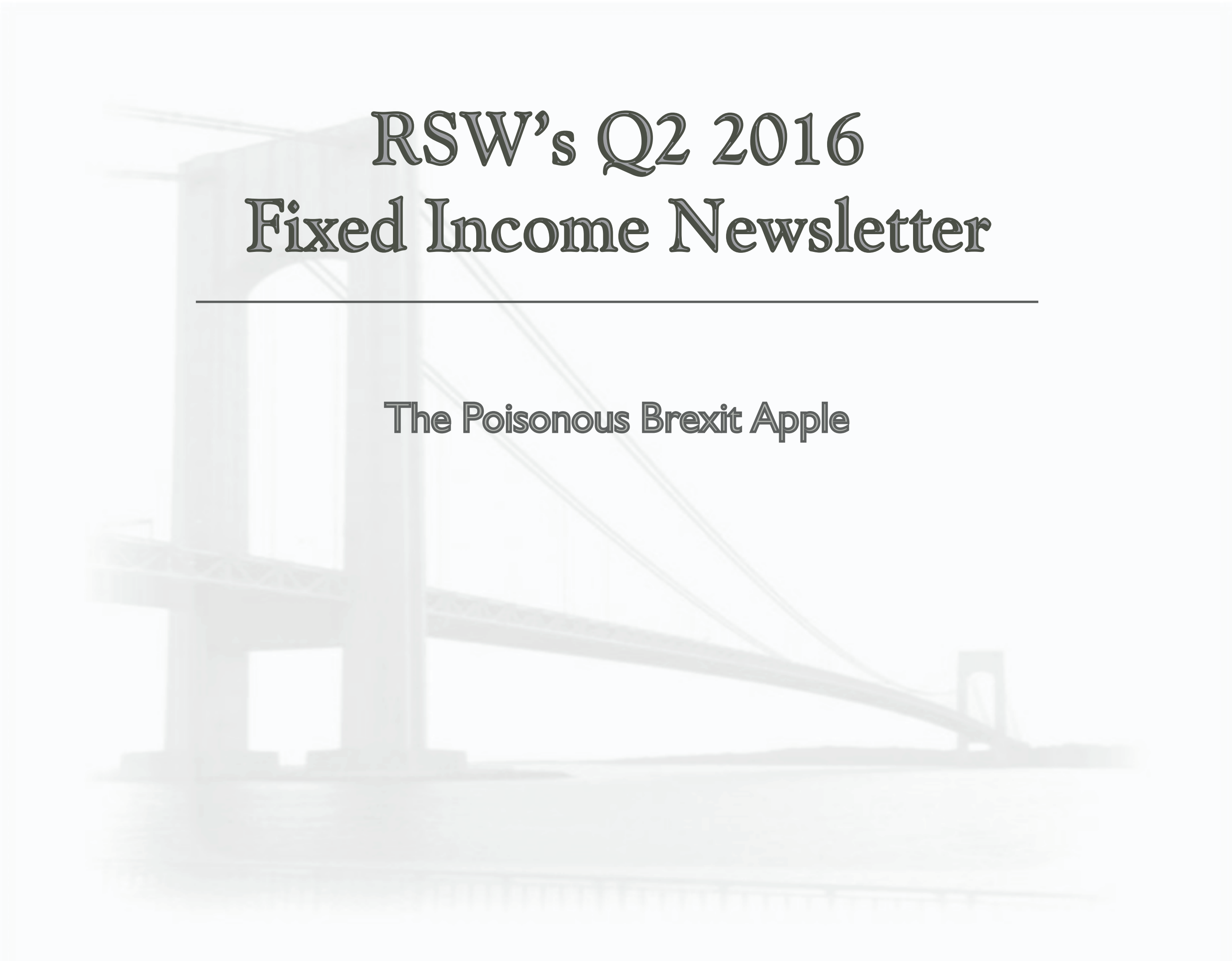
July 13th, 2016



RSW's Q2 2016 Fixed Income Newsletter

The Poisonous Brexit Apple

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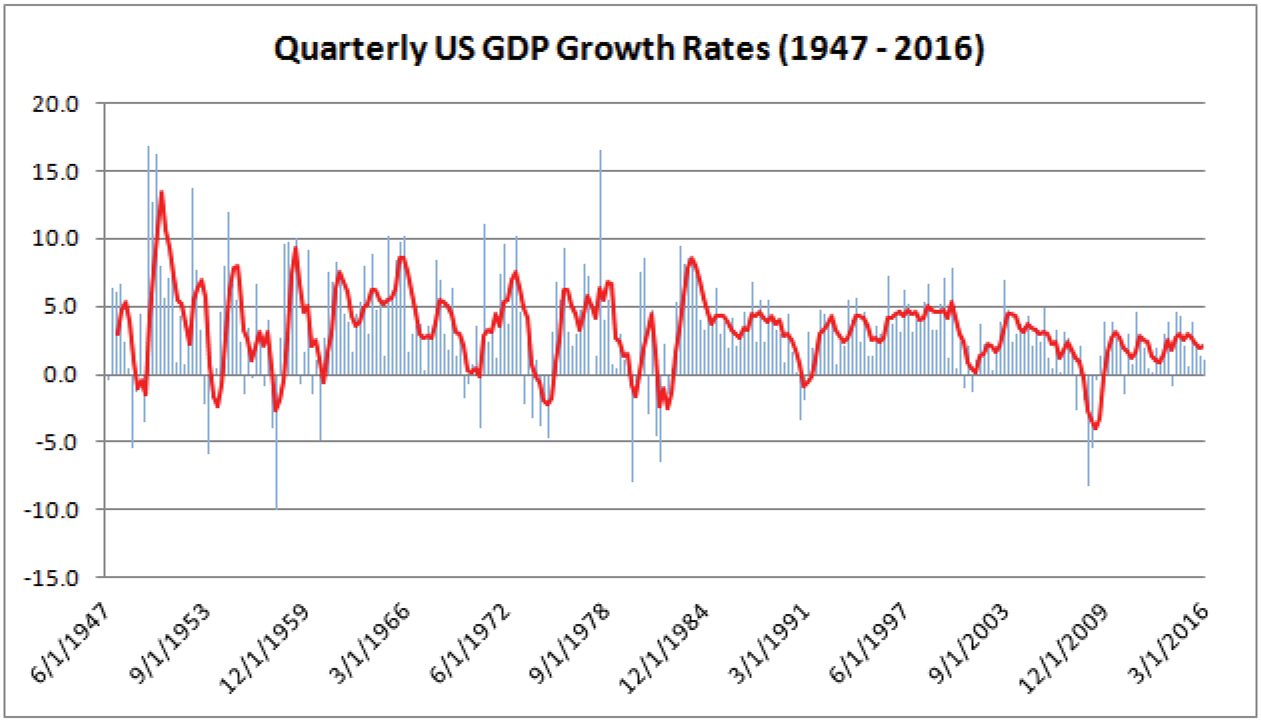
The Poisonous Brexit Apple

We at RSW trust that the debate about world economic activity returning to "normal" anytime soon should be just about over. After purchasing sovereign, corporate, high yield bonds, ETFs, equities, and assets still unknown, global Central Banks have failed in their mission to change the trajectory of growth and inflation.

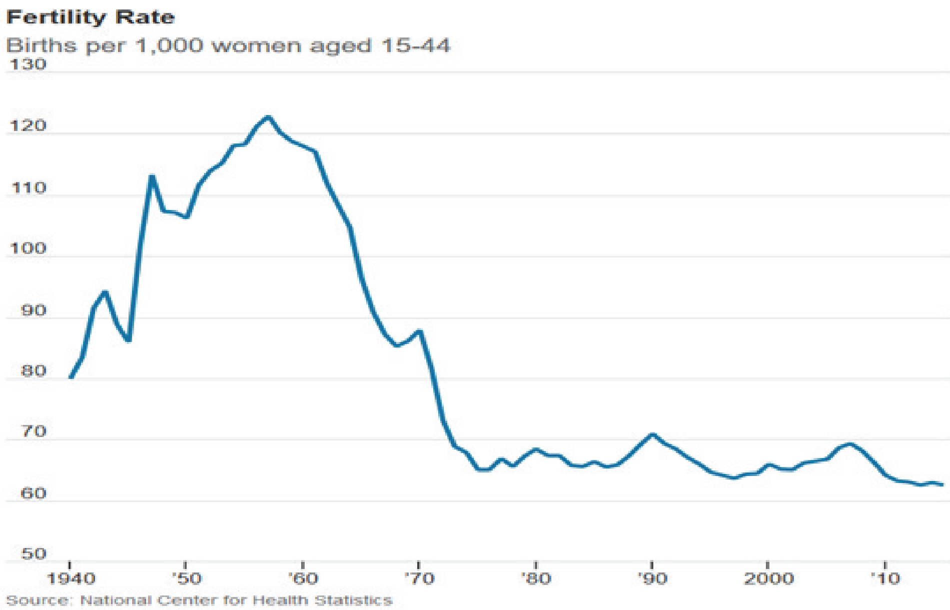
We who function in the financial markets daily, consider reports on unemployment, retail sales, industrial production, housing starts, etc., to try to gauge growth, inflation, and the direction of interest rates. In reality, what we observe are secondary and tertiary branches of the tree called growth. The twin tap roots of that tree are population growth, and productivity gains. To humanize them, they are the Adam and Eve of GDP, while we and the markets analyze the offspring.

Ours is a world of “saw-toothed” graphs where quarterly GDP (post financial crisis) “prints” of +4.60% versus (-5.40%) matters. 250,000 jobs created versus 50,000 moves markets, and 0.50% retail sales growth versus unchanged makes a difference. Central Bank actions to be argued do have some effect on each of these. What they haven’t touched is the slope of the trend line seen below:



Lights Out

Seen in the chart below, young children have become a shrinking portion of the overall population. While current Central Bank policies are designed to ignite the "animal spirits" of investors, consumers, and businesses, these policies can't influence how the descendants of Adam and Eve behave when the lights are turned out. Simply put, their animal spirits are not being ignited as they are clearly not having enough kids!



Encapsulated in this single chart above is half of the culprit of economic stagnation: Low Birth Rate. While we breathlessly await each utterance from Janet Yellen or economic release, this macro trend acts as a gravitational pull on growth.

This relentless aging of the world's population has created an embedded reduction in consumer spending, and frightening growth in the level of unfunded liabilities. A static or declining younger populace with historically high unemployment rates must fill the void and pay for the promised entitlements. Even a return to historic growth averages cannot undo the “demographic tsunami”.

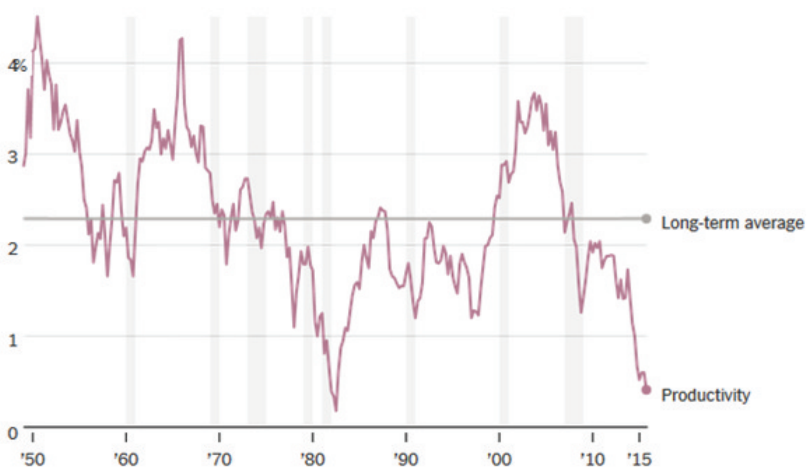
A report by the McKinsey Global Institute predicted that due to the declining birth rate, the pace of GDP for the 20 largest economies are predicted to contract by 40% over the next 50 years. The implications for declining tax revenues versus exploding debt and unfunded liabilities should be a concern for anyone who knows basic math or uses their fingers or toes.

We Are What We Produce

Recently, Alan Greenspan appeared on three major business channels and seemed unmistakably distraught about the potent mix of 9% entitlement growth worldwide and declining productivity. The previously mentioned McKinsey report also highlighted this topic and estimates that productivity would need to accelerate 80% from its historical average of 2-2.50% (currently under 1%) for global growth to return to trend.

If population growth is the Adam, then productivity is Eve. It is the mother of all long term growth and principal reason why many citizens are wealthier both than their grandparents and third world countries. Specifically, productivity measures how efficiently production inputs, such as labor and capital, are being used in an economy to produce a given level of output. Here is Mr. Greenspan's concern:

Five-year rolling average of annual productivity growth



Shaded areas indicate recession.
Source: Labor Department

It is an economic certainty that if the birth rate and productivity stagnate or decline, GDP growth rates will follow. RSW's concern is that Adam and Eve have been banned from the garden.

Across the Pond

It is a shorter trip than you think from the Garden of Eden to Buckingham Palace where disenchanted voters took a bite of the poisonous Brexit apple. The dynamics of growth that we have discussed don't only exist in an economics book; they have been playing out in the real world. Low birth rates and declining productivity give us the trend line in the first chart (GDP), and that line on the page carries with it a real cost on human lives. What economists like to call "the economic pie" is shrinking. Labor's share of that pie has diminished, and has shifted to the labor forces of developing nations.

If our assessment is correct, then social and political upheaval should not surprise us. Chronic unemployment, stagnant wages for 60 to 70% of us, increased medical costs, and a global accumulation of debt are just some of the forces creating a sense of social unease. We should not be shocked when this economic insecurity, anger, fear and hostility manifests in a Brexit. Immigrants, fairly or unfairly, become easy targets and "the man", also called Brussels and Washington, becomes despised and not totally without justification.

While the forces that created the Brexit vote are complex, varied and historic, part of what caused the vote exists in most corners of the globe. If the developed world continues to grow at 1-2%, labor loses share, and loses to emerging economy labor forces, while unfunded liabilities grow at 9% annually, Brexit is only the first of the names that will be coined. As others react to the quarterly changes in GDP statistics and choose to embrace its importance, remember that the weakening long-term trend provides the roadmap to BREXIT, just as it is the formula for lower rates and lower returns.

Municipal Bond Commentary

During the second quarter, the municipal market continued to produce strong results with longer-maturity bonds turning in the best performance. This produced a "flatter" yield curve as robust demand and limited supply remained central themes. The municipal asset class has produced positive returns for 12 straight months and demand remains strong, as mutual fund flows have been positive for 41 consecutive weeks. Beyond the continued supply and demand trends we've seen in 2016, a foreign appetite for yield has strengthened demand for positive yielding debt.

On June 23, following the UK's vote to exit the EU, safe haven assets such as US Treasury (with tax-exempt bonds following) and tax-exempt municipal bonds took another leg down in yield resulting in further price gains. We have also seen an increase in foreign buying as their hunger for yield continued on the back of an expanding number of global monetary authorities that have adopted negative interest rate policies. With the US representing roughly 60% of the world's positive yielding debt, it's easy to see why US Dollar Denominated debt has become a more attractive investment.

It is now almost 8 years since the Great Recession was officially declared "over". Nevertheless for many states and municipalities, weak growth has exposed the "structural" deficiencies inherent in the fiscal affairs of many issuers. Connecticut and Pennsylvania are prime examples. Both states have been subjected to multiple downgrades with more to come. Connecticut's budget shortfalls remain unresolved despite layoffs, expenditure cuts, rainy day fund draw-downs, and a billion dollar plus tax increase. In Pennsylvania, two years of protracted budget impasses, its lack of reserves, and a five-fold increase in unfunded pension liabilities over the last 10 years to just over $50 billion, put the state in a deep hole. Our proactive approach to credit analysis has allowed us to minimize longer maturity exposure to these issuers.

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