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RSW's Q2 2017 Fixed Income Newsletter

Pick the Winners, Avoid the Losers

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No, this musing will not be about RSW's can't miss strategy to identify the picks for next seasons' fantasy football league. This will be a serious conversation about the corrosive effects of soaring debt and its first cousin, unfunded liabilities. Maybe these promises are not technically debt, but try explaining that to a Social Security and Medicare recipient, or a retired Federal worker who thought the promises were real. We call it "effective debt" since failure to fully meet these obligations would affect markets on the same magnitude as a missed interest payment. While we don't believe this is necessarily imminent, the cost to fund these obligations will only serve to increasingly constrain the Federal government's ability to meet future liabilities.

To be a successful investment manager in today's "Brave New World", we must be able to adapt to observable market forces as well as less obvious or anticipated events. Each economic release or utterance from FOMC chair Janet Yellen attracts many eyeballs and prompts much debate. Yet 100% debt/GDP on a Federal level or a doubling of corporate debt is met with deafening silence.

The Japan Syndrome

Studies have concluded that having debt levels at 100% debt/GDP constrains an economy's growth prospects. Japan is often cited as an exception, since their debt/GDP is 250%, and they have not yet entered into economic collapse. With that said, just because Japan is not yet in financial ruin, doesn't mean their economic activity isn't actively deteriorating. After 25 years of radical monetary and fiscal policies, they are unable sustain 2% growth or 1% inflation.

The decade's long trend to lower rates has encouraged complacency about mushrooming debt. For example, if you borrow $1000 at 4% and the rate declines to 2%, your servicing costs are $20. If you double your loan to $2000 and rates rise from 2% back to 4% the debt service is $80 or 4X. In the U.S. we have doubled our national debt from 10 trillion to 20 trillion with an approximate five-year average maturity. The five year Treasury note has risen from 95bps last July to 195bps today. Risk happens fast and so does debt service.

So today's scoreboard reads: $20 trillion in debt and more importantly, $105 trillion of "effective debt" i.e., unfunded liabilities. These unfunded liabilities are the value of what we owe to Social Security, Medicare, Federal pensions, and income security if these liabilities stop growing today. As financial market participants, we should better appreciate that missing one dollar in Social Security payments would have the same market effect as missing one dollar of interest payments. It might be helpful if we use the concept that "effective debt" is roughly five times larger than "legal debt". As Alan Greenspan said, "How can we ignore unfunded liabilities growing at 9% annually, while we grow revenues at 2%?"

Debt is Debt, No Matter What You Call It

We as municipal professionals may have a clearer picture of the problem due to our immediate and growing concern regarding unfunded pension liabilities and retiree health benefits. The most egregious example among other weak states is Illinois. The state has approximately $37 billion in general obligation and appropriation debt outstanding with another $6 billion in deficit financing shortly on tap. Depending on which valuation you may consider, the state's unfunded pension liabilities range from $135 billion to $250 billion. In other words, these obligations range from an approximate 4 to 7 times the debt outstanding. While you may not consider this to be a hard debt obligation, the Illinois State Supreme Court does, ruling that these pensions must be honored and paid. This is the main reason that the state's credit rating borders on junk bond status (this could happen by the time you read this).

Over the past 10 years we have argued that the Great Recession did not cause the growth downshift, it exacerbated an existing trend. In our view, the real culprits were a low birth rate and low productivity which largely negate the Central Bank attempts to jumpstart growth back to the "Glory Days". Our purpose is to make two points: first, debt is among the most important factors in impeding growth and second, our "effective debt" is many times worse than the legal numbers cited. These forces are conspiring on a Federal, State and Corporate level to blunt the positive effects of past super easy monetary policy and proposed future fiscal policies. We have endured a parabolic spike in total debt of all descriptions, without the proportional spike in economic activity. While debt has not "paid" for a proportionate growth in the level of economic activity going back to the 1980's, today the situation has deteriorated further. Currently, approximately $4.00 of debt is needed to generate $1.00 of GDP. While in the 1980's, it only took $1.77 to generate an additional $1.00 of GDP growth.

As a higher and higher percent of budgets go to support past unfunded promises, taxes are raised to close the funding gap. Monies on a Federal, State and Local level are diverted from productive investments such as infrastructure, education, and job training. To compound the problem, funds are being taken from those with a propensity to spend and invest; such as a first time home buyer. The funds are being transferred to those who spend reluctantly and mostly on necessities, which causes further deceleration to an already historically low money velocity. We have never seen this, only Japan has.

Conventional Wisdom is Not a Substitute for Instinct

In a recent commentary, we discussed economic conventional wisdom and how outdated "facts" are used to form opinions, make judgments, and take action. We feel superior to our ancestors because they believed the earth was flat, while our economic thinking may contain similar flaws. How does the Fed model something that has never happened such as 10,000+ people retiring every day for the next 19 to 20 years? And what happens when a Federal Reserve raises rates in a 500% effective debt/GDP world?

Some municipalities are a microcosm of the challenges the Federal Government is facing. But while the debt of a nation is theoretically the strongest, it is also true that there is no substitution. In other words, you either buy sovereign debt or you don't. Like our corporate brethren, however, municipals offer many possibilities within the asset class.

While generally conceded to be a notch below the creditworthiness of U.S. Treasury debt, municipal obligations have one key advantage that can be exploited by a professional manager. Well over a decade ago, we saw the dangers of runaway unfunded pensions in Detroit, Chicago and Puerto Rico. Applying those same math lessons, we see that Illinois, New Jersey and Connecticut are on a similarly dangerous path. There are healthy entities and municipalities within our country that we view as safe havens and they compete for our investment dollars. Just as in the early 2000's when airlines went bankrupt due to legacy pension obligations, investors found safer venues. With that said, no one should sugarcoat this central idea: if a country finds itself in true financial difficulty, every asset class could be somewhat affected.

What Does All of this Mean?

So while Illinois, Connecticut, and New Jersey are today's headlines, others are sure to follow. Although the landscape and investing environment are in flux, our job as money managers is not. In the most significant way, our job will not change at all. We are charged with the mission of picking winners and avoiding the losers. Long ago, we learned not to gamble ON Atlantic City, only to gamble IN Atlantic City. What we have realized before most is that the state of New Jersey must be using the same actuary. What seems like a new idea to some is that entities once thought to be immune from poor financial management, are not. Just ask the debt or equity holders of GE how they wound up with a $31 billion pension shortfall. As always, we will remain highly vigilant as the structural headwinds causing these dislocations are not likely to dissipate anytime soon and should worsen over time.

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