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# RSW's Q3 2015 Fixed Income Newsletter

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When Push Comes to Shove

Municipal Bond Commentary

### When Push Comes to Shove (10/9/15)

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Whenever Janet Yellen speaks to the financial community about the economy and the possibility of raising the Federal Funds rate, for us it conjures up images of the stereotypical "school yard fight". There is plenty of tough talk of lunch money being taken and punches being thrown. The inevitable outcome, is a pushing contest that ends with more threats of punches being thrown at some unspecified time and place in the future. While we don't dismiss the possibility that Yellen will eventually throw a punch, our mindset is that she is too afraid that the world economies and markets would punch back.

It is apparent that investors and traders are totally absorbed in the when "Lift off" (rate hike) will begin. Even acknowledging its importance, we will explore why the Fed has continuously failed to "launch". As posted in previous RSW correspondence, there remains a yawning gap between the Fed's characterization of economic conditions and its actual performance. For too long we have heard from the Fed that the economy is "healing", that growth is "accelerating", that growth is becoming "self-sustaining", and that the Fed wants to begin to normalize interest rates.

Fast forward to today. If the consensus forecast for Q3 2015 GDP estimate of +2.40% is correct then the growth rate for the first three quarters of 2015 will come in at an average of +2.30%. Against this backdrop, we believe that there are four questions that should have been posed to Janet Yellen during the Question and Answer session that followed the announcement of the Fed's interest rate decision.

1- When has the Federal Reserve ever raised interest rates when the economy was growing at 2.30% and decelerating?

2- San Francisco Fed President John Williams called the vote to hold rates at zero a close call. Even allowing for definitional differences, would you classify one dissenting vote (Jeffrey Lacker) as a close call?

3-If you are getting closer to a rate hike how do you explain the sudden appearance of a negative interest rate projection by one of the Federal Reserve Board members? (Board members anonymously offer projections for the future level of the Federal Funds rate: "dot plot chart").

4- Ms. Yellen, in the past you stated: "In government institutions and in teaching, you need to inspire confidence. To achieve credibility, you have to very clearly explain what you are doing and why". Do you believe your rhetoric is instilling confidence?

Where we are going with all of this is the belief that a lack of clarity and resoluteness has caused the beginning of a crisis of confidence. We see signs that a loss of credibility has shown up as additional market instability. The Federal Reserve has delivered so many contradictory messages that they have created unwanted uncertainty. We at RSW have been left with one inescapable fact:

The Fed has consistently overestimated the strength of, or at least the staying power of, the US economy. Even if the Fed was consistently wrong, but adjusted policy on those beliefs (i.e. raise rates), market participants can act accordingly. When the Fed talks tough (need to hike) and doesn't act, market participants lose trust. Simply put, you can call the economy relatively weak, and hold rates at zero. You can call the economy moderately strong and gaining strength and raise rates, but you Can't call the economy moderately strong and healing and hold rates at zero.

The second topic to discuss is the why the Fed stayed put may have more implications longer term than whether GDP grows at 1.50% or 2.50%. For the first time that we can recall, events outside of the U.S. border may have played an equal part in the Fed's latest decision. In fact, both the IMF and World Bank insisted that the Federal Reserve take a rate hike off the table given the fragility of the worldwide economy and financial markets. Yellen addressed this directly during her prepared statement: recent global developments "may restrain economic activity somewhat and are likely to put further downward pressure on inflation".

For all of us charged with managing money, our task can be distilled down to this. We need to be able to navigate the "Institutional noise" and evaluate our world the way it really is. What should be crystal clear by now is that Central Banks are neither all knowing nor all powerful. In fact, the Fed has been so consistently wrong in overestimating growth that there are only two possibilities left for us. Either their Fed models or the people analyzing the results of these models are not adequate. Or secondly, they feel a need to paint a

rosier picture than the one that actually exists. While we don't distrust everything that Central Banks say we are always mindful of what Jean Claude Juncker (Euro-finance Minister) once said: "when it becomes serious you need to lie".

At RSW, our consistent and long held belief has been that interest rates would stay lower for longer, that deflation is spreading around the globe, that our most formidable obstacles remain structural, and that Fed policy can't and hasn't laid a glove on any of them. Our persistent stance has caused us at times to be labeled "always negative". Our respectful rebuttal is that negativity would be an appropriate label if economic conditions were actually improving, or already healthy. But things are not that way! We have simply been guilty of being accurate and "below consensus". Akin to a golf tournament, we have always understood that we are playing on a hole that rewards being "closest to the pin". It seems that the Fed and pundits have mistakenly thought that they are playing on the hole that rewards the "longest drive". We may sound like a broken record but if economic conditions don't change our tune won't either.

After \$4+ Trillion dollars and countless pep rallies by the Fed, our GDP remains stuck at 2%. No, we don't believe that our "economic roof" will collapse, but there are cracks in the foundation that are beginning to widen globally despite money creation at dizzying levels. In the end, we believe "talking up the economy" and claiming the necessity for a rate hike, was a gambit by the Fed aimed at calming the nerves of investors and the public at large. Unfortunately for all, it seems to have done the opposite. Janet Yellen may attempt to give the appearance of someone who is ready to fight, but when "push comes to shove", it is likely that she will continue to back down. Just because you see her taping-up her hands, putting on her gloves, and putting in the mouthpiece, doesn't mean that Yellen is ready to throw the first punch.

### **Municipal Bond Commentary**

Tax-exempt yields reversed course during the third quarter, with bond prices rising rather steadily. Contrary to the relatively high level of interest rate volatility exhibited in the U.S. Treasury bond market, tax-exempt yield movements were more muted. For example, 10-year U.S. Treasury bond yields fluctuated in a range of 45 basis points (.45%), closing the quarter at 2.04%, compared to a 30 basis point (.30%) range for comparable maturity "AAA" rated tax-exempt securities. Municipal bond yields closed the quarter at 2.03%, nearly 100% of Treasury bond yields.

Perhaps the most important factor serving to dampen the volatility in the municipal bond market was the lack of "*net* new issue supply" offered for sale in the municipal bond market. Net supply can be calculated *by subtracting matured and called bonds from newly issued bonds*. September's new issue volume of roughly \$18 billion was by far the lowest monthly amount of bonds to come to market this year. In stark contrast, monthly volume has been averaging approximately \$34 billion.



Virtually half of the \$277 billion of new municipals that have come to market this year have been “refunding bonds” which have not added anything to the available net supply of outstanding bonds. In fact, “New Money” new issue volume through September of \$110 billion is only a paltry \$4 billion more than the same period last year. Although it won’t be a straight line, we expect net new issuance over the next 6 months to remain relatively low.

Several issuers continued to dominate the headlines during the quarter. Puerto Rico, New Jersey, Illinois, and Chicago (issuers RSW does not invest), served to shine a bright light on the under-funded pension obligations facing some jurisdictions. Despite these negative credit stories, we have remained constructive on the financial health of higher quality municipal issuers, and have always been mindful of the pension challenges when selecting creditworthy borrowers. Furthermore, despite an announcement of a restructuring in Puerto Rico debt, it has become apparent that investors are not “painting the marketplace” with a broad brush as the issuers who have been more fiscally responsible have performed relatively well.

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