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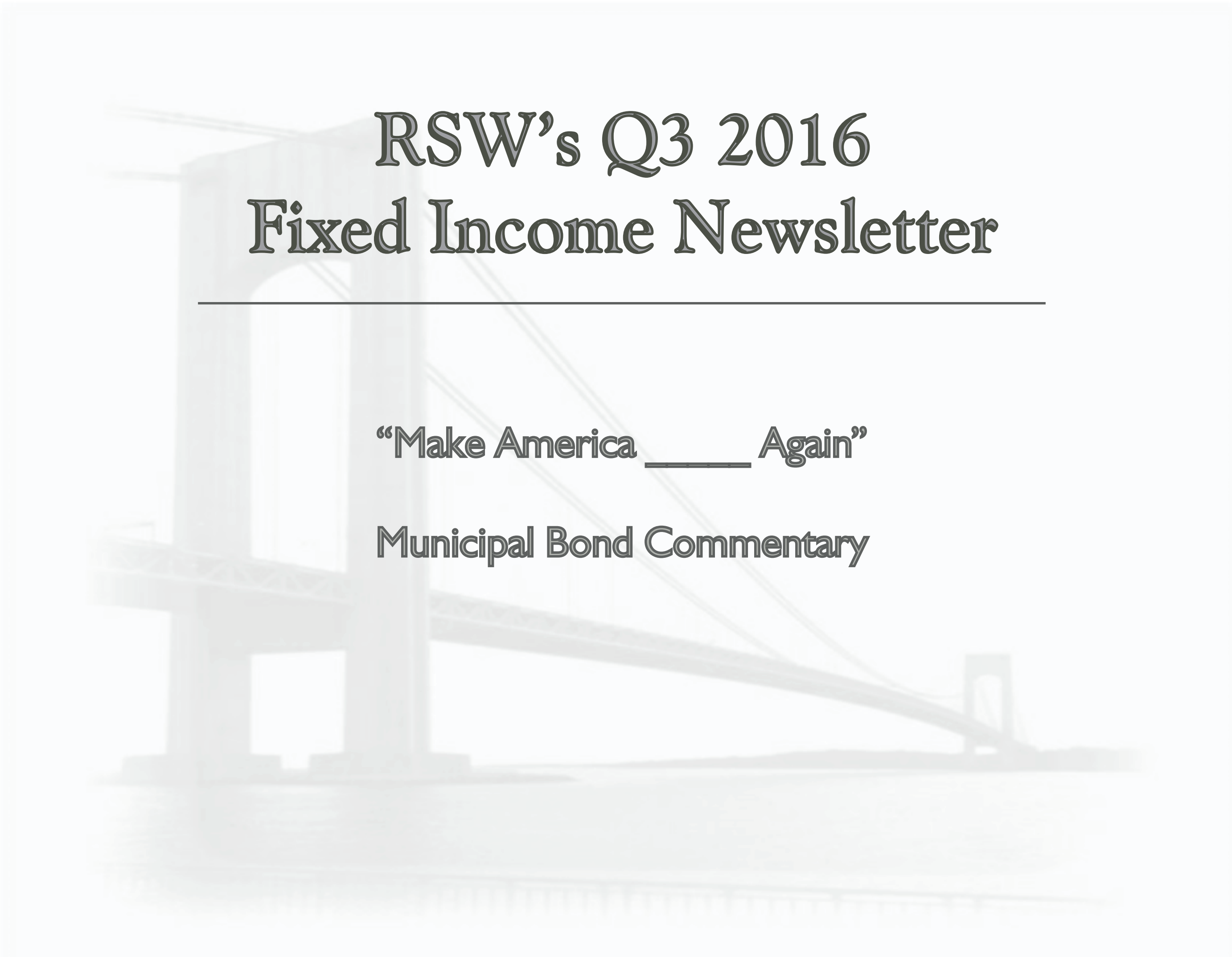

RSW's Q3 2016 Fixed Income Newsletter

"Make America _____ Again"

Municipal Bond Commentary

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“Make America _____ Again”

Recently, I attended a wedding and elegant reception at a wonderful venue for the son of one of our key employees. It was a great evening, and aside from the observations that are typically discussed about the festivities, there were some less obvious remarks that are noteworthy. The first is that some people you would expect to be there simply didn't make the guest list. Secondly, those who prepare the meal and clean up afterwards don’t have as grand a time as the rest of us. Having enjoyed the great company, food, and music, those of us who attended should admit that the setting, while elegant, couldn't seat everyone, and some gained admission only as "servers".

Just like a wedding reception which has a social "pecking order", so too has globalization created a new world order of economic winners and losers. The initial battleground was fair trade, or in many cases unfair trade, as currency wars were waged by the world's Central Banks. By flooding the financial system with their local currency, Central Banks competed to drive down the value of their “home” currency. This caused the prices of its goods to fall, and related exports to rise. It has now become a central topic in our presidential politics, and will undoubtedly be an undercurrent in the numerous European referendums and elections over the next year. More and more the outcome of trade policy for industries or countries, is leaving a trail of winners or losers with very little in-between. At the wedding, you are either at a table of prominence, or a dark table in the corner close to the kitchen, or worse, you have to be on the dance floor doing the chicken dance with Uncle Harry.

Decades ago, globalization was thought to be a rising tide that could lift all boats in poor and rich countries alike. The story is simple. With multinational corporations creating hundreds of thousands of new assembly line jobs in emerging nations where the cost of labor is cheaper, the middle class in those regions would swell, thus propelling higher local consumption. As this occurs, more factories would be needed to meet the increased demand, further raising local standards of living. This new found wealth could then be spent by an enthusiastic new customer base.

Decades later, with the benefit of 20/20 hindsight, the profile of pros and cons of globalization have become clearer.

Pros:

- More and better products at cheaper prices than ever before.
- Smaller developing nations can compete with larger developed nations.
- Skilled labor can move more freely across borders.
- Increased flow of information and technology among nations.

Cons:

- The Walmart dilema. Millions can buy more "stuff" for less, only because millions have lost high paying manufacturing jobs to cheaper overseas labor.
- This phenomenon has put downward pressure on the number of workers participating in the job market, wages, availability of economic opportunity, demand for goods, and the level of economic optimism.
- As high paying jobs leave developed countries social "safety nets" fray.
- Globalization has accelerated and intensified wealth inequality.

I think we can all agree that the ranking that you assign to each positive or negative consequence, and whether your society realizes a longer list of positives than negatives will drive your opinion of globalization. There is no "secret sauce" for weighing the pros and cons as each nation, or industry will have their own unique perspective as to what open trade does for, or to, their society. With that said, we believe that the strongest (United States should be at the top of the list) most developed nations have disproportionately suffered varied and substantial negative consequences due to this global rebalancing of products and labor.

Cocktail Hour

Today's world of free-trade agreements seems to be creating an environment that is driving a negative social mood that threatens to destabilize or radicalize world politics. Chief culprits are: jobs immigrating to low-cost countries, suppressed wages due to foreign competition, technology replacing humans in virtually every industry, and deteriorating environmental conditions in developing nations.

Whether you detest Donald Trump or support him, he has hit a nerve with his campaign slogan "Make America Great Again". The millions who despise everything about Trump should remind themselves not to confuse the message and the messenger. It may be tempting to dismiss his followers as possessing only a few brain cells with a capacity to only perform basic bodily functions. However, for many, Trump symbolizes that we (USA) were "on top" once, and now we are not. For some, it means a loss of influence on world events. For millions of others, it's nothing more than a fond wish to return to a job that paid $50 per hour with Cadillac benefits to build cars or forge steel. For others, perhaps they may be longing for an age when their accounting job wasn't performed by a computer program. And do we really doubt that there are scores of teachers who dream for an America in which there is no need for metal detectors in its public schools?

It doesn't matter that globalization isn't the cause of all economic and social ills. When people feel vulnerable, powerless, ignored and unsure of their future or their children's, they look for culprits.

We at RSW, believe that BREXIT (shorthand way of saying that the UK is exiting from the European Union) could be considered shorthand for "Make Britain Great Again".

Best Man Speech

If anyone at this point would like to ask where all of this is taking us, the correct answer is the most unsettling: we don't know, nor does anyone else! What we can tell you is that the seeds of socio-economic upheaval are everywhere. Not every election or vote will have a disruptive outcome, possibly very few, but that is not the point. As large portions of the globe perceive themselves as negatively impacted by globalization people tend to lash out. It doesn't matter that winners have done nothing wrong. Losers or those barely hanging often look for a bad guy to blame. When trade is perceived structurally to cause lower growth, fewer high-paying jobs, less job security, and a threat to social safety nets, extremes can seem appealing. In any society when “those without a seat at the wedding” and “those who are only there to serve”, begin to outnumber “those comfortably seated”, political movements often arise to address inequities, real or imagined.

Father/ Daughter Dance

So when you see or hear the slogan "Make America______ Again", your world or political view will determine if you fill in the blank with xenophobic or exclusionary. Others may fill it in with safe, #1, or even leave great. Whatever your view, it behooves us all to appreciate that it is driven by your place in the banquet hall, or at least your chance of obtaining one. In Charles Dickens' *Oliver Twist*, Oliver approaches the schoolmaster with dinner bowl extended and says, "Please sir, I want some more". The schoolmaster replied with an astonished, "What". History is packed with times when too many had their faces pressed up against the window looking in. And when they were greeted with indifference or outright ridicule, they found ways of asking for more, sometimes without the please.

We are now seated and ready to be served

Over the last decade we have described many forces that are piling up to create huge deflationary headwinds (demographics, debt, etc), but the one's described in this musing are no less important. It used to be that citizens could rely on 3% or higher GDP, rising incomes, a brighter future, and feelings of security. It is fair to say that globalization did not "start the fire" but it has certainly accelerated the process.

The changes that are taking place tell us that we are not going back to where we once were, at least anytime soon. Once again, we at RSW are reiterating our call for lower levels of inflation, a slower pace of GDP (likely remaining below 2% per annum), and yes, returns on virtually every asset class lower than historical returns.

Municipal Bond Commentary

After years of tepid growth following the great recession, tax collections are actually slowing down. This has implications especially for those jurisdictions that are straining to balance budgets in a structural manner without deficit spending or by various non-recurring parlor tricks.

Of equal concern are governmental pension liabilities. While this may sound like we are beating a "dead horse", recent studies note that these risks are growing exponentially.

Changes in Tax Revenue Growth

- According to Census Bureau data (as published by the Rockefeller Institute, September 2016), state property, sales, corporate and personal tax collections grew at only a paltry 1.6% during the first quarter of 2016 when compared to the same period in 2015. This is significantly lower than the 5.7% average for the previous 4 quarters. The declines were across the board and most visible in sales and withholding taxes. Preliminary 2016 second quarter tax revenue growth figures are estimated at still only 2%.

- Preliminary second quarter data shows that slower growth is widespread in about half of the states and are not limited to oil producing states.

- In short, we continue to emphasize investment in strong high grade credits as lower investment grade issuers will continue to be hard pressed to confront spending pressures in a slow revenue environment.

More on Public Pensions

The Rockefeller Institute presented a study ("Standards and Metrics for Public Retirement Systems") at a conference on September 26, 2016 that we summarize as follows:

- The study reports that U.S. public funds have become the biggest risk-takers among pension funds internationally. State and local pension plans have increased their exposure to equity like assets while private plans have significantly lowered theirs.

- Public plans since the recession have increased their equity like exposures from just over 50% to 65%, while private plans lowered exposures from 60% to 40%.

- The reason for the large uptick in equity exposure is two-fold : to make up for prior underfunding and to keep governmental contributions low minimizing the use of scant tax payer dollars.

The study states that a one standard deviation shortfall would be up to 4x's and 10x's greater than in 1995 and 1985 respectively.

- Even the best funded pension plans are on the same roller coaster with the worst funded plans with respect to longer term investment returns. Changing demographics with people living longer than when these plans were originated compounds the scenario.

- It is for this reason that we continue and will continue to shun those states and municipalities with significant unfunded pensions. They continue to be hard pressed to raise taxes and/or curtail services in a relatively weak economy . It is easier to kick the can down the road as "the road goes on forever".

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