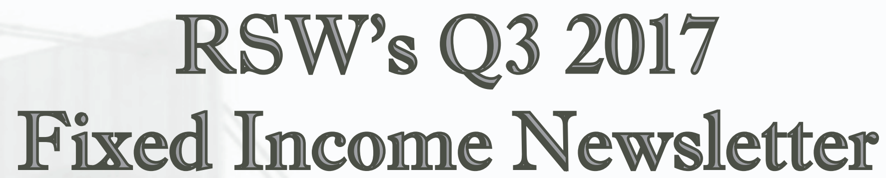
October 10, 2017



The Buck Stops Here

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Among the many memorable wisecracks from former President Harry Truman was his knock on economists. He once said, "Give me a one-handed economist. All my economists say, 'on one hand'... then 'but on the other'...". While sympathetic to his frustration, we grudgingly admit to understanding why many prognosticators refuse to take a strong stand on their forecasts, as there is a seemingly endless stream of crosscurrents and anomalies in the world's economic order. The list is lengthy so we will only highlight those that stand out.

Crosscurrents

We have experienced a period of job growth like few in history, resulting in a "virtual full unemployment" rate of 4.2%. Against this backdrop, the sluggish pace of retail sales seems to be one of those facts "that doesn't belong". With moderate but consistent GDP growth and some wage gains, retail sales should have been all but assured to accelerate. However, the last three months have seen a marked slowdown as consumer spending has decelerated from a growth rate of 5.1% at the end of the first quarter of 2017, to just 3.9% in August (as measured by the BEA's personal consumption expenditure y/y change). Adding to the economic contradictions is the rarity that this decline has been accompanied by an impressive rise in virtually every consumer confidence reading.

Friday's September employment report was a perfect microcosm of the difficulty in deciphering the economic message. In a job market averaging an increase of 175,000 per month, 33,000 jobs were lost in September, likely due entirely to recent hurricanes. Average hourly wages that struggled to exceed an increase of 0.2% per month in August, accelerated at a rate of 0.5% in September. This was largely due to the interruption of low wage jobs being eliminated, while salaried employees continued to get paid. Even the drop to a 4.2% unemployment rate may include some hurricane related noise. We will need to see how these forces net out over the coming months.

Immediately after the election, risk markets (equity, high yield corporate bonds, etc.) and high-quality bond markets reacted to prospects of stronger growth and higher inflation. Risk markets have doggedly held to the inevitability of President Trump's programs being enacted while the bond market has traveled a more convoluted road. Economic growth while consistent, remains underwhelming. The 2% targeted inflation rate remains elusive, yet deflation risks seem to be abating. Tax reform and its promise of stronger growth seem no more certain than six months ago. All of this seems to be the very definition of crosscurrents.

Meanwhile, the FOMC has announced it will soon begin to reduce the size of its balance sheet. Since the Fed began purchasing U.S. Treasury bonds and mortgage securities (QE's), they have been reinvesting all the proceeds (maturities, call and coupon payments) of their "portfolio", by purchasing additional bonds. As the Fed reduces the size of their reinvestment (purchasing fewer bonds) by pre-determined amounts, we believe there should be additional upward pressure on market rates as demand is tapered. Furthermore, upward pressure on rates could result from a greater level of U.S. Treasury financing needs resulting from our nation's growing annual budget deficit, now totaling $690 billion.

The Federal Reserve is insistent that a December hike in the short-term Federal funds rate is on the table. What has happened to market rates given all the positive talk on growth and the imminent threat of a tightening? After the immediate post-election spike to 2.60%, 10- year treasury yields have irregularly declined to a low on August 29 of 2.02% and now sits at 2.35%. It is not a radical thought to say some of the facts highlighted above shouldn't be able to coexist without market interest rates or risk markets being mispriced.

We challenge you to look back in economic history to find a period of similar economic and geopolitical risk coexisting with the VIX (Index that measures the volatility of S&P options) under 10. For reference, the long-term range of this index has fluctuated between 9 and 90. Similarly the "trading range" over the last twelve months for 10-year U.S. Treasury bond yields has also been stuck in the mud, with rates only fluctuating between 2.02% to 2.60%; the tightest range in over 65 years.

"There is some risk involved in action, there always is. But there is far more risk in failure to act."

What we have termed people "feeling frozen", may be more properly named people "being complacent". For those of us who are asset allocators and money managers, our job is to weigh the divergent and even contradictory factors and decide on a definitive course of action. As total rate of return managers, we are responsible for assessing when to enhance income by extending the duration (interest rate sensitivity) of our client portfolios and when to concentrate on the preservation of principal by reducing duration. While many investors and pundits believed that 10-year U.S. Treasury bond (market benchmark) yields would breach 2% months ago, as inflation was falling and geopolitical tensions rising, we held different beliefs. We felt that it would take an actual event, not just the fear of one, to cause 10- year U.S. Treasury bond yields to fall below 2%. This theory was tested during the quarter as benchmark Treasury yields fell to 2.02%.

At this juncture, while fully recognizing that US rates are attractive (relatively high) versus European and Japanese rates, we at RSW have reduced the level of interest rate sensitivity (duration) of our client accounts. This positioning, which in many instances was implemented during the summer months, puts our average portfolio durations near the lowest levels since we opened our doors in 2005. This positioning however, is indicative of our temporary view of rates. RSW's decades old call for lower than historical rates and remaining lower for longer, is still in force.

Underscoring this long-term prognostication is our continued view that there are self-breaking mechanisms in place, which structurally prevent yields from rising dramatically, in any sustainable way. Simply put, our economy is dependent on low U.S. Treasury interest rates and narrow credit quality spreads for issuers of debt obligations. Should yields rise precipitously, then borrowing will become more expensive, and risk assets of all stripes should be re-priced. As in the past, this event should act as a natural brake on economic activity and could easily intensify the economic fractures that have already begun to appear.

Our position of aggressive defensiveness in duration is partially borne from the abnormally low ratio of municipal yields relative to Treasury bond yields. Using 10-year "AAA" rated tax-exempt bond yields as a barometer, the ratio today stands at 85%. As you may recall, late last year the ratio was higher than 100%, as 10-year tax-exempt yields were higher than comparable maturity Treasury debt.

There has been a long-established historical pattern in the municipal asset class. This pattern shows that at relatively low levels of interest rates, the ratio of municipal to Treasury bond yields should be higher. "On the other hand", this ratio tends to fall as yields rise. Much of this can be gleaned from the buying patterns of individual investors who tend to be less aggressive investors as yields are declining and more aggressive when yields are rising. So, over the summer when both **yields** and **ratios** fell together, it screamed for us to be cautious of interest rate risk.

There will surely continue to be a long list of market occurrences that are counterintuitive and even contradictory, so we will all have to deal with incongruity in economics and markets. So two-handed economists will continue to fill the business press and presenting various outcomes may actually be a requirement of their discipline. For those of us charged with protecting and increasing wealth, we must resolve the conflicting evidence with a course of action. Our job is to thoughtfully execute that most famous of all Harry Truman quotes:" The buck stops here". And we think that buck, at least over the near term, commands that we should have less interest rate risk.

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