Is the U.S. Economy Sprinting?

The fourth quarter ended on a positive note as U.S. economic activity showed signs of a broad healing process. Some highlights include:

- The Index of Leading Economic Indicators scored its eighth consecutive month of positive change.
- Labor market conditions are improving as new monthly jobless claims continue to fall.
- Temporary employment and average hours worked have increased.
- Manufacturing growth continues to expand.
- Existing home sales and home prices are rebounding.
- Inventories of new and existing homes are falling.

...Or Just Limping?

So, against this improving backdrop, why are we at RSW ***not*** exuberant about the growth prospects for the U.S. economy? Could it be that we are a fixed income shop and all bond guys tend to be relentlessly negative? While that is certainly possible, I will let you draw your own conclusions about our thesis, objectivity, and prognostication track record.

While the statistics are relatively more robust as of late, we are perhaps more concerned with "looking under the hood" and understanding the origins and the resulting expense of creating this improvement. The way we see it, Washington, D.C. is the source of the improved data: they have created a huge debt monetization (print dollars and buy Treasury bonds) experiment that is set to expire in the first half of 2010, established artificial stimulus plans that could be borrowing from future growth (incentives to homebuyers and builders to act now), and removed mark-to-market accounting rules. While we have seen some of the benefits of these policies, a spike in the Federal red ink and a surge in Treasury borrowing offer a glimpse into just some of the costs.

With the third quarter 2009 GDP measuring just +2.2% (down from the last revision of +2.8%) it is hard for me to imagine that the Federal Reserve will begin the process of draining liquidity (tightening monetary policy) from their pool sized "punch bowl". With that said, this is the latest debate taking place among the Federal Reserve Board members. I just can't imagine why! By historical standards, the U.S. is in the midst of a mild economic expansion with not a whole lot of organic "umph" behind it. In October, the U.S. unemployment rate topped 10% for the first time in 26 years, and it is expected that the country will finish the decade with fewer jobs than existed at its start. Unfortunately, we believe that the unemployment problem will be with us for a while as the economic recovery is fragile and corporations are awash in excess capacity. Therefore, it is crucial that business investment be in a position to take the baton after the effects of government stimulus and the restocking of depleted inventories begins to fade in the second half of 2010.

Despite the many positive economic signals, enthusiasm for the recovery remains fairly muted among consumers, and a persistently high level of unemployment is doing nothing to encourage them to open up their wallets. With over 70% of the U.S. economy dependent on the consumer, the trillion dollar question should be whether or not consumer spending returns in earnest. In the past, consumers supported economic activity by coming back from economic downturns with a more ravenous appetite for goods and services than they had before the downturn. This time around, with the consumer in a de-leveraging mode we have serious doubts as to their ability to deliver the necessary spending payload.

Municipal Bonds

Tax-exempt yields rose steadily during the fourth quarter, virtually mirroring the movement in the Treasury bond market. Overall though, the municipal bond market scored very impressive returns during 2009. There were a number of dynamics that contributed to the year's notable results, but for the sake of brevity I will touch on just a couple of topics. First, the yield relationship between tax-exempt and Treasury bonds reverted back to their historical relationship. Simply put, this means that in 2008, many market participants adopted a Treasury only mentality where they grabbed only for those bonds that were deemed to be bullet proof. Virtually all other fixed income asset classes aside from Treasuries were punished. This year, as some investors abandoned their bunker mentality, they began to seek bonds that offered superior value. This benefited the tax-exempt market, as some individuals exchanged Treasury bonds for municipal bonds.

Secondly, the level of new issue supply versus investor demand is currently being recalibrated. The amount of bonds being issued is important, since it can have a notable impact on the supply-to-demand dynamics that could greatly influence bond prices. It is important to note that the pace of new issuance tends to affect bond prices to a greater extent than exchange traded securities such as equities. With the supply spigot always open, individuals acting as the dominant purchaser, and the fact that tax-free's are not listed on an exchange, these dynamics make them more sensitive to supply-to-demand variations. So, what's our point? As many of you know, the taxable municipal bond market continues to expand. Prior to 2009, taxable municipal bond issuance averaged just 5% of all municipal bond supply. However, in 2009, taxable municipal bond issuance mushroomed to 20% of all municipal bond offerings courtesy of the Build America Bond (BAB) program. In fact, some prognosticators expect that BAB issuance may exceed 30% of this year's total $450 billion municipal bonds priced in the market. This means that the universe of available bonds is shrinking as demand for the bonds has remained relatively strong and has thus propelled prices higher.

Ok, enough about where we have been and why. What do we think about the year ahead? As you would expect, our thoughts have not changed since the release of RSW's '2010's Market Outlook' just several weeks ago. Just to summarize: [we believe that investors should not expect the same robust returns witnessed over the last twelve months. Just as 2008 was an anomaly where the municipal indices lost value, so too were the returns recorded this year. In contrast, some pundits are "pounding the table" about the "cheapness" of the tax-free market given the likely rise of future tax rates. Although we agree that tax rates are likely to rise considerably, we believe that some additional credit downgrades will absorb much of that benefit. Therefore, we believe that the tax-free market is close to being fairly valued relative to our Treasury brethren. Lastly, some state and local governments may put-off making the politically unpopular decision of slashing budget expenditures or raising taxes. However, the apparent self-breaking mechanism in these instances is the Press. As news surfaces about "an issuer in crisis," government officials miraculously seem to implement some of the difficult but necessary measures. We must be mindful that all states except Vermont (another state we choose not to extend a loan) must balance their budget annually.

As we all know too well, this does not mean that the legislative process will be uneventful and painless].

Sincerely,
Robert S. Waas