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RSW's Q4 2016 Fixed Income Newsletter

Conventional Wisdom? No Thank You!

Municipal Bond Commentary

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Conventional Wisdom? No Thank You!

"Never accept ultimatums, conventional wisdom, or absolutes." – Christopher Reeve

Conventional wisdom refers to any belief that is widely held, shapes behavior, is typically accepted at face value, and rarely questioned or challenged. These strongly held beliefs expand the spectrum of topics ranging from economics to our nation's politics. They take the form of talking points, where statements are repeated over and over and become "conventional wisdom", whether they are true or not. In short, we believe conventional wisdom acts as a road block to independent thinking.

That same conventional wisdom took a particularly hard hit in 2016. It gave us: "Brexit will never pass", "Trump has no chance to be elected", and if he won "stock prices would fall by 10 to 20%." Also, remember these conventional wisdom classics:

- We are at the end of the long term bond bull market ("truth" for over 8 years)
- Soaring oil prices will unleash 1970's style inflation
- Collapsing oil prices will unleash a powerful wave of consumer spending
- The Federal Reserve's QE (Quantitative Easing) strategy will spark a return to "normal" GDP growth
- Interest rates earned on investments are never less than zero (tell that to European investors)

In each of these instances, and others, we at RSW remained steadfast in our view that the headwinds of extraordinarily high levels of debt, aging demographics, and declining levels of productivity will continue to pressure future sustainable growth prospects.

Our current situation today shares much in common with the past. Today, we at RSW are once again refusing to accept conventional wisdom. There is a general acknowledgement in the financial community that an aggressive fiscal policy can accomplish what an aggressive monetary policy could not. The four drivers of fiscal stimulus that President-Elect Trump has targeted are: a reduction in corporate and personal income tax rates, repatriation of overseas cash, infrastructure spending and reduced government regulation. Ours will not be an argument against this newfound optimism for the success of these policies. It is merely a caution about the near unanimity of the extent and effectiveness of these programs, the time it will take to fully implement them, and their eventual success.

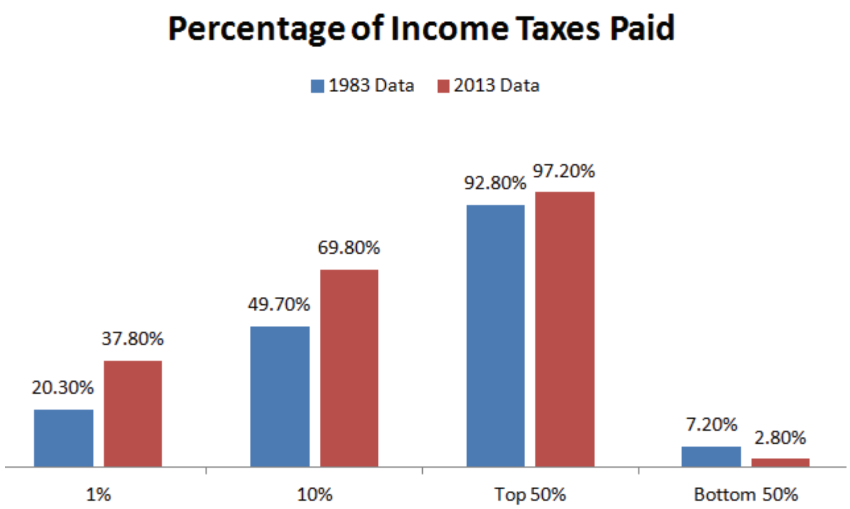
Taxes

Corporate Tax

The reduced corporate tax rate proposal has drawn much attention and positive feedback. <u>The bottom line is that taxes could be reduced from 35% to 15%.</u> While we also believe that a reduction in tax rates is an economically positive event, we believe the positive reaction may be exaggerated. To this end, the GAO (Government Accounting Office) found that the "effective rate" (what corporate America actually pays after exclusions and deductions) was 22%. It was further found that approximately 42% of corporations pay no income tax. If you combine these facts with the reality that some House and Senate leaders favor a 20% rate, you will be left with a fraction of the projected economic impact, compared to what the headline promises. The fact is that there is simply no way to know exactly what is finally enacted, but it is fair to say that even a cursory examination makes disappointment possible, if not likely. Furthermore, if the legislation limits the amount of deductions so that every corporation, in the end, must pay something, tax rates would actually rise for 42% of corporations.

Individual tax policy

The proposed reduction in individual tax rates is perhaps another example of economic conventional wisdom. From a growth perspective, any reduction in taxes holds the opportunity for increased investment. However, in today's society where 45 to 48% of the population pays no federal income tax, can tax cuts have the same impact as they have had historically? And, if 5% of U.S. citizens pay the lion's share of the taxes, can a cut really stimulate growth? We have a phenomenally changed society since the 1980's with respect to income and distribution, and yet markets act as if a cut is a cut.



In essence, as you can see from the above chart, since President Reagan's tax cut was enacted, a growing pool of citizens are paying a lesser share of our nation's total federal income taxes. Historically, it is important to note that tax cuts have served to stimulate economic growth, as the middle class responds by changing their spending patterns. Today however, given the reduced size of the middle class, the policy will by definition affect fewer people. Again, everything is relative. Those who are in the top 1% of wage earners may on the margin alter their spending patterns, but those who earn less may take advantage of a perceived "windfall," and spend a greater percentage of the cash freed up by a tax cut.

Repatriation

Repatriation of overseas cash is probably the next biggest market darling. Here again, we can't know what overall effect this could have as there are many unknowns. The plan involves offering a discounted tax rate to U.S. multinational corporations, thereby incentivizing them to "bring back" the monies they have accumulated overseas. The reason for the buzz around this policy is the hope that jobs are created when the cash is used to expand U.S. operations and additional workers are hired.

The optimism surrounding this policy can turn out to be premature. First, we can only assume that at the outset, some of the monies, when repatriated, would be used to pay down some of their debt. Secondly, the cash that will potentially be brought back to the U.S. is owned by only 25 companies, and most are concentrated in only two sectors; pharmaceutical and technology. Can large amounts of liquidity residing in relatively few hands, skewed to two sectors, spark a broad based economic event?

This is similar to a 2004 repatriation tax holiday, when after being enacted roughly $360 billion was brought home, at a 5.50% tax rate, and those monies were primarily used to pay dividends, and repurchase company stock along with M&A (Merger and Acquisitions) activity. Therefore, we cannot assume that a large chunk of these monies would be used for business investment or job creation since corporations are already sitting with over $2 trillion in cash domestically.

Infrastructure

Infrastructure is the most difficult of topics because so much of the policy is unformulated. There is a justified fear that a one trillion dollar stimulus plan would be a budget buster with the potential to swell deficits. Today, this fear seems premature, as there has been much communication from Mr. Trump that the plan contemplates an element of private funding or a private/public funding partnership. There seems to be a general agreement that this type of spending will create jobs and be at least a temporary growth enhancer, but to change the nation's long-term growth, a boost in the productivity rate is also required.

Such a growth enhancer occurred with the building of our interstate highway system, bridges, tunnels, our power grid, and even the Hoover Dam. However, there are legitimate questions as to how much productivity is enhanced when you repair a bridge compared to building what was not there before. While we can make a stronger argument that some companies will be clear beneficiaries, the overall effect on the US economy is less certain.

So we would like to say again, that all of this leads us to be either believers nor non-believers. It just seems to us at RSW that there are so many moving parts yet to be decided and enacted that it seems foolish to all pile onto one side of the boat. It is likely that if President-Elect Trump gets everything that he wants, in the size that he wants, and the timing that he wants, that yields will likely rise, and prices of some risk assets should improve. If on the other hand, Mr. Trump's plans are scaled back and happen much more gradually than he would like, it is not far-fetched to believe that all of the financial markets (yes including interest rates) may have overshot as investors were driven by prevailing conventional wisdom.

Conclusion

As we enter 2017, we do so with an equal amount of excitement and trepidation. As was discussed in RSW's Intra-quarterly communication, political risk is the most difficult if not nearly impossible to predict. The geopolitical landscape is changing rapidly and dramatically as a populist movement sweeps across the globe seeking to replace globalism with nationalist values. The political landscape has shifted, and in our opinion, we are now moving away from a period that once marked the "New Normal."

Political factors are far more difficult for investors to integrate into their analysis, but it is imperative to do so. Therein lies the main challenge for all of us in the years ahead. We can certainly envision many instances where political forces overwhelm economic considerations. This past year certainly gave us a hint of what is possible. Conventional wisdom can make us all too sure of how events will unfold. In basketball, "slam dunks" are almost a sure thing. In investing, sometimes sure things can be "air balls."

Municipal Bond Commentary

While the equity market responded enthusiastically to the unexpected outcome of the US election, interest rates, especially for longer-maturity bonds, rose dramatically. In atypical fashion, during this episode, tax-exempt yields spiked at a quicker pace than comparable maturity U.S. Treasury bonds. For the quarter, the total rate of return of the Barclays Capital Municipal Bond Index (broad based index comprised of over 40,000 securities) declined by (-3.62%).

As U.S. Treasury and municipal bond yields soared, many individual investors (who own the majority of the outstanding municipal bonds) responded by liquidating their municipal bond mutual funds. To meet these redemption requests, mutual fund portfolio managers were "forced" to sell tax-free securities into a declining market. These activities served to exaggerate the price declines as the pace of selling dwarfed the broker/dealers appetite to add to their bond inventories.

The ensuing supply-to-demand imbalance caused municipal yields to rise faster than their U.S. Treasury brethren. In fact, at one point, yields on 10-year tax-exempt bonds exceeded Treasury debt. This drove the ratio of municipal bonds yields to be valued at 108% of comparable maturity Treasury bonds. Today, this ratio, while historically elevated, has meaningfully declined, and now stands at approximately 92%. Please See RSW's 2017 Investment Outlook, where we communicated our thoughts as to what we believe is in store for 2017. In addition, within that publication, we estimated the annual total rate of returns an investor in RSW's Market Duration strategy could expect should interest rates rise by 100 basis points. Our models projected that individuals could expect to lose roughly 1/2% (50 basis points). In other words, with all of the excitement from the pundits and the media describing the drubbing that investors will suffer by investing in bonds, it may be more hype than reality. Besides, given the fragility of the economy, geopolitical risk, and high overall levels of debt, we view the likelihood of such a rise as being remote.

Recapping the 2016 Election – State and Local Governments

- Republicans dominated the 2014 midterm elections, electing 31 governors and by controlling both state legislative houses in 29 states- the highest number since 1920. Democrats controlled both houses in only 11 states and only in 7 states did they also control the governor's mansion (the lowest number since the Civil War when there were 15 less states).

- The 2016 election saw further significant Republican gains electing 33 governors – tying a 94 year old record while establishing a record high by winning 69 of the 99 state legislatures. The Republicans now control all three governmental branches in fully 25 states, while Democratic dominance fell to only 5 states. Over the recent and midterm elections, Democrats lost approximately 1,000 state elected seats.

Tax receipts are slipping:

- State income and sales tax collections as reported for the second quarter of 2016 actually declined by 2.1% from the same period one year earlier, compared to an average of +3.70% for the four prior year-over-year percent changes. Specifically, personal income tax collections declined by 3.4% during this same period compared to an average of approximately +7% for the previous 4 quarters. Year-over-year growth in durable goods consumption was reported to have declined from approximately 5% in the second quarter of 2015 to just less than 3% in the first and second quarters of 2016.

- Fully 27 states saw actual declines in tax collections during this period. The nation's average decline was just over 2%.

Unrelenting Expenditure and Pension Pressures Continue Amid Relatively Weak Revenue Performance and Highlights the Need for a Disciplined Investment Strategy.

- This is especially relevant given the recent upturn in interest rates. Concurrent with the interest rate rise, credit spreads have widened for lower rated investment grade municipals as well as high yield bonds. We see no value in these stressed credits as the "floor" for such issuers has yet to be reached.

- The future will be here shortly - Aggregate state general fund spending has mushroomed from approximately $470 billion in 2000 to an estimated $820 billion for fiscal year 2017. The pressure on revenues is unabated and growing. Tax increases, where enacted, are not panaceas for ongoing and longer term pressures exacerbated by growing mammoth unfunded pension liabilities, but act as only band aids and patches for today's structural deficits. In short, significant upticks in economic activity, for many states and jurisdictions, will still fall short.

Where We Stand Today

- We have for some time ignored, divested, or shortened durations for those issuers with massive and growing unfunded pension and retiree health benefits. To be blunt, for many states and municipalities, strategies to confront these issues over the intermediate and longer terms are hard to envisage let alone implement. Tomorrow's headlines will be upon us in relatively short order.

- We are in the neighborhood of the Great Recession being 8 years in the rear view mirror and yet high profile downgrades still prevailed during the year. Such downgrades included the states of Connecticut, New Jersey, Illinois, Kansas, Kentucky, New Mexico, North Dakota, West Virginia, Mississippi and of course Puerto Rico.

On a Positive Note

- Approximately 45% of RSW portfolio holdings enjoy "AAA" ratings reflecting the strength of their individual credit profiles or the escrows of U.S. Treasuries of pre-refunded bonds.

- Credit rating upgrades of the remaining non-"AAA" portfolio holdings exceeded downgrades by a 3:1 margin and equaled approximately 13% of this portion of the portfolio.

In terms of credit quality spreads, the municipal market has differentiated between the "wheat and the chaff." To that end, yields have risen faster on lesser quality borrowers, compared to the entire market being punished because of the financial challenges of a relative few. Akin to how the equity market is a market of stocks, the municipal bond market is a market of issuers. For example, budgetary concerns in the issuers highlighted above have not spilled over to the broad market. Looking ahead, we believe that the market will only penalize the "chaff" for the foreseeable future.

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