



If We Don't Build It, They Can't Come (12/11/12)

2012 in Review

With the demolition derby we call the election cycle now mercifully behind us, it is time again for us to sit down, contemplate, and impart our insights. As always, we start with a review of previous musings to get a sense of where we have hit the "bull's-eye" and where we missed the mark. Each of you gets to assign your own grade to the analysis, but we believe that it is accurate to make at least two observations. The first is that in the "Brave New World", we have always tried to "think outside the box". We have resisted the idea that the Fed can save us with liquidity, and have continued to predict subpar (versus history) economic growth of 0 to 2% as far as the eye can see. At the same time, we have always resisted engaging in "end of the world" talk as well as comparisons to the Great Depression. Lastly, we do not believe that after this deleveraging process ends, we will enter a renewed period of above-trend growth.

Our second observation is that we were, before it was fashionable, referring to what currently ails the United States as "structural" in nature. Said another way, we have made the argument that debt, demographics, deleveraging, deflation, income inequality, and a declining education system were more resilient than the "cures", of a QE 1-2 or 3.

2013 Prognostications in Bold Type

U.S. Economic activity, as measured by GDP will grow in the zero to two percent range.

- ❖ *For the first three quarters of this year, GDP averaged 2% while the consensus forecast for Q4 2012 stands at 1.50%*

Deflation remains in force.

- ❖ The Consumer Price Index fell on a year-over-year basis from 3% to 2.2%. In addition, average hourly earnings rose 1.1% in the latest 12 months to October, the weakest growth rate since Labor Department records began in 1965.



Municipal defaults will remain scarce, especially among the higher quality borrowers.

- ❖ While there was a small uptick in the number of “rated” municipal defaults, they remain well under ¼ of 1%.

10-year municipal bond yields, currently valued at over 100% of Treasury bonds, should decline to below 85%.

- ❖ The percentage of Municipal bonds versus Treasury bond yields declined to 87% in January 2012.

U.S. Treasury 10-year bond yields could reach 3% should a spike occur, quickly settling back down to around 2%.

- ❖ While the “trading range” in 10-year U.S. Treasury bond yields equaled 100 basis points, the “back-up” in yields was approximately 60 basis points short of the high end of our prediction (2.40% versus 3%). In addition, yields have declined by 40 basis points more than we projected.

Manufacturing Meets the Trade Deficit

Upon revisiting previous RSW commentaries, some things stand out. We have spent much time directing your attention to such an array of socio-economic variables affecting our economy, that sometimes the nucleus of the problem can be obscured. Our focus today will attempt to hone in on what could be considered the main source of our economic infection, and our thesis could be titled “The Decline of American Manufacturing and the Resulting Trade Deficit”. While true that this topic has not been totally ignored by the pundits, it is often referred to more as an effect than a cause of the decline of the U.S. economy. Some of us “seasoned” (it sounds better than old) professionals can remember the mid-1980’s when the financial markets froze, convulsed, and lurched up or down based on the release of monthly trade deficit figures. While in hindsight we can say that the market overreacted to each release, it may be fair to say that it is equally foolish for the market to virtually ignore this economic series and its long-term implications. In 2011, The U.S. trade deficit exceeded \$558 billion dollars, which represented an 11% increase from the year before. This deficit represents a wealth drain that is not caused by debt, demographics, deleveraging. It is caused by the decline of U.S. manufacturing.

For the last 25 to 30 years, the proportion of manufacturing jobs versus service sector jobs has changed dramatically. In fact, in terms of jobs, the U.S. manufacturing sector’s shrinkage has accelerated since 2000, resulting in the largest number of jobs lost since the Great Depression. Over the last decade, our nation

suffered a loss of 5.7 million manufacturing jobs, which represents fully one-third of ALL manufacturing jobs. Despite this disturbing phenomenon, the story goes largely untold. Just think of our own behavior on the first Friday of every month. We wait breathlessly for report on the number of jobs created, and once again, as in the “olden days”, the markets freeze, convulse, or lurch up or down with the release. We don’t quarrel with the number’s relevance; we simply contend that it overshadows the real story. In our last commentary we cited a study on the quality (low, medium, high) of new jobs being created. During the recovery phase, 58% of the jobs “regained” were low paying and only 22% were medium paying. This is consistent with reports that median income has declined 8.2% since 2008. We will seek to explore the demise of our domestic manufacturing sector, and try to answer why it is happening and why it is so important.

For illustrative purposes, let’s examine the characteristics of a purely service oriented economy with one where a manufacturing component is added in:

Service economy:

- Limitations on growth.
- Most functions do not lend themselves to enhanced productivity, as only one person can be served at any given time.
- Profit margin expansion is limited to raising prices for the service provided.
- Jobs in the service sector are more “generic” (i.e. less highly skilled) in nature, and less influenced by competitive price pressures.
- Wages are also less elastic, since few specific skills are needed.
- All the functions are performed “in-house”, meaning the amount of wealth generated is limited to the services exchanged among the country’s citizens.

Now let’s add some manufacturing:

- Buyers of your manufacturing products from abroad represent money coming into your country that you otherwise would not receive.
- The economy has to naturally expand to meet the demand of the additional buyers of goods produced.
- This can produce a situation where the need for workers exceeds the available pool in a given sector. An example is the North Dakota oil fields where there are more jobs currently available than qualified workers.

- When the number of job openings exceeds the pool of available workers, wages rise.
- Stronger employment and higher wages mean higher tax revenues.
- When employers can't fill all of the positions with the current labor pool, they invest more heavily in technology.
- The investment in technology expands economic activity.
- Workers become better skilled and more productive.
- Employers speed their pace of innovation, employing better technology to enhance worker productivity.

Multiplier Effect

There is also another dynamic at work that shines brighter in the manufacturing arena compared to the service sector. The concept, known as the multiplier effect, can best be described by using an example: an accountant who prepares his client's tax return is paid for his service. Although the client was happy with the service, and the accountant was happy to be paid, no money was added to the economy as only a transfer of wealth took place. Additionally, the value of a particular product was not enhanced, and no raw materials are worth more after the transaction.

In contrast, when raw materials are converted to a finished product, each new process to complete this transformation adds jobs. This is true not only for those involved in the manufacturing of the product, but also for those who support its distribution such as marketing and transportation. In fact, according to the Manufacturing Institute, every dollar from a manufactured product's sale supports \$1.40 in output from other sectors. A sales dollar in the service sector, on the other hand, supports on average only \$0.71, according to the National Association of Manufacturers.

Ultimately, when a manufacturing based economy confronts rising demand, wages go up, skills go up, tax revenue goes up, and everyone gets richer. All of this is made possible because a thriving manufacturing sector allows its market to expand to the world's global demand. While manufacturing jobs may not be the most glamorous, many are higher paying than service sector jobs and they remain the seed that makes a booming, expanding middle class economy possible.

At RSW, we believe the concept of a trade deficit is often misunderstood. On a monthly basis, while the dollar amount fluctuates, more money is leaving the United States by way of trade than is flowing in. Some believe that this differential is synonymous with debt. This is not the case however, as America doesn't owe China



a stack of money because its citizens purchased more from China than China purchased from America. So while a trade deficit is not debt, it is truly a transfer of wealth. Said differently, this is the revenue that America could have earned had our manufacturing output matched the same level of exports as other countries.

While technology is often correctly credited with aiding productivity and job creation, we believe we have entered a part of the economic cycle in which technology is contributing to job losses in certain industries. It is also likely that technology may be exacerbating the socio-economic ill of income inequality. From the early to late stages of the “tech cycle”, great wealth is created for those inventing and implementing the “new technology”. However, for those workers on the real world front lines, the position of “burger flipper” may be your new fate, as laborers and middle management types are displaced by smarter and cheaper machines. Where we are in this cycle may be industry specific, but the overall trend has become undeniable, irreversible, and structural.

This process is corrosive, as higher paying jobs are exchanged for lower ones, causing tax receipts of all stripes to decline. To fill the void, the Federal Government attempts to make-up the difference through, food stamps, medical payments, stimulus, and a multitude of transfer payments. The reality is that the national economic pie is shrinking. While debt can mask the problem, it then becomes the problem.

A Year In Preview

2013 Forecasts

- U.S. Economic activity, as measured by GDP, will grow in the zero to two percent range. (Downside risks are “working overtime” if the data falls outside our projected range, we expect it should be because growth is below trend type growth).
- Deflation remains in force.
- Municipal defaults will remain scarce, especially among the higher quality borrowers. Rating downgrades should continue to outpace upgrades.
- RSW’s projection for municipal performance is clouded by tax issues, which are being debated as Congress debates the issue of the “Fiscal Cliff”. Please click on the “Crossing the Bridge” section of www.rswinv.com for our November publication entitled “Fiscal Cliff, Municipal Bond Interest, and the Chop” for more details.
- U.S. Treasury 10-year bond yields could reach 2.25% should a spike occur, with the floor for yields being 1.10%.



Municipal Commentary: Stop, Look, and Listen

As we approach year-end, interest rates in many fixed income categories are at near generational lows. While we at RSW have consistently forecasted a declining interest rate environment, we must admit that the 2012 “rally” exceeded our expectations. With that said, at today’s low level of interest rates, investors should temper their expectations about future levels of total return from virtually all segments of the fixed-income sector, not just municipals. In fact, with only a modest amount of price appreciation remaining to be “wrung out” from interest rate declines, judicious credit research, clever portfolio positioning, tactical transactions, rolling down the yield curve, and a prudent sell-discipline are among those strategies that should be increasingly important in the upcoming interest rate cycle.

While the popular press may write about a “bond bubble”, we see little evidence to support such an argument. We believe, notwithstanding the potential for a fall down the “fiscal cliff”, that there is little to move muni yields to a higher trading range. The one threat to this premise would be a wholesale change to municipal tax exemption under any tax reform agreement- an outcome we think unlikely.

Municipal Technicals Give No Reason to Support a Breakout from Current Trading Ranges

Approximately \$344 billion of municipal bonds came to market through the first 11 months of 2012 -- a 31% increase over the same period last year. However since 2010, the total municipal debt outstanding has declined by approximately \$100 billion to \$3.7 trillion. What explains this?

Simply put, over the past few years, the par value of bonds issued for new money purposes declined dramatically, while the par value of refunding bonds issued to refinance existing bonds at lower interest rates increased significantly. The net impact is that fewer bonds are currently available at lower interest rates, as existing holdings at higher interest rates were redeemed and called from client portfolios. Throughout 2012, demand from individual investors has remained high -- not only for new additions to holdings, but in order to replace redeemed bonds from existing portfolios.

Double-Edged Sword

Since the Federal Income Tax became permanent in 1913, municipal bonds have enjoyed a special status. Since investors do not pay federal income taxes on their muni bond earnings, governments can afford to pay these savers lower interest rates than other types of borrowers.



With the IOU's of the Federal Government continuing to mount, and budget negotiations ongoing, a variety of revenue enhancement strategies are being contemplated. At the top of the list are tax hikes for the rich. While one would normally expect higher tax rates to escalate tax-exempt bond demand, currently, there is another "edge" to the story.

As law makers scramble to expand their search for revenue by looking under every stone, current deductions and exemptions of all stripes for the "wealthy" are under siege. Currently in the crosshairs is the exemption of municipal bond interest. Some current proposals suggest plans to cap the municipal bond interest exemption at 28% for municipal bond interest payments.

In our opinion, a reduction or elimination of this exemption will likely result in meaningful increases in municipal borrowing costs, and diminished access to capital. As a result of these proposals, numerous state and local government groups are mobilized to lobby in favor of maintaining the status quo — to preserve the exempt status of municipal bond interest income. While we still do not believe that it is likely that municipal bond exemption will be curtailed, we candidly admit that political risk is always the most challenging risk to handicap. Therefore, we can only offer a logical explanation why changing the tax-exempt status of municipal coupon income is not necessarily straightforward.

Headlines We Expect to See in 2013: "The Weak Get Weaker"

Pension Reform, Bankruptcy and Default, Illinois and Puerto Rico

We have seen it already; the *New York Times* dedicated front page columns, including the lead story, on various occasions towards the close of 2012 to municipal pension issues. We suspect that these headlines will appear with greater frequency in 2013:

- Pension issues in Illinois and Puerto Rico are catastrophic.
- Puerto Rico yield spreads are widening, going against the market, while credit spreads in a low interest rate environment remain tight.
- San Bernardino, California is not making pension payments to CalPERS (the state pension agency) as part of its bankruptcy plan. Lawsuits, ultimately, may or may not address the protection of pension benefits under the state constitution.
- Various municipalities in California filed for bankruptcy protection with defaults.
- Detroit with "CCC" ratings borders on the brink of immediate insolvency.



While we believe that the economic and inflation “picture” are investor friendly and continue to be supportive of these low market yields, there are reasons to stop, look, and listen -- but not to “stop, drop, and roll”. Above, we have described several forces that could pressure the prices of municipal bond prices this year. With that said, investors need to stay focused on their investment objectives, the relative credit safety of the municipal bond market, and temper their expectation for future total returns that can be generated in the tax-exempt market, given the overall market levels we are currently experiencing.

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