

### Is Now the Time to Exit the Cave? (4/12/13)

The most recently released DreamWorks animated feature, entitled "The Croods", is an exciting adventure that your whole family should enjoy. The Croods tells the tale of a family of cavemen who find themselves in the midst of one wild predicament after another. The dad (Grug), sets family policy, and his number one rule is: "Never leave the cave". Furthermore, Grug believes that you should never explore the outside world because "New is always bad. Never not be afraid!"

Facing such a rigid mentality, daughter (Eep) soon starts to rebel and push the boundaries set by her dad. Eventually, Eep comes across a stranger (Guy) who claims that the world is ending, and that the Croods should relocate immediately. After a series of mishaps, the family follows Guy to find a "safer" place to live, despite the father's fear of venturing outside his cave.

Similar to Guy attempting to entice Grug to "see the light of day", the Federal Reserve is coaxing investors "out of their cave". By playing an active role in driving down the overall level of U.S. Treasury interest rates (via Quantitative Easing strategies), investors have been busily fleeing low yielding securities in search of higher returns. In fact, at RSW, we are generally surprised by how far the additional liquidity served to boost and maintain the overall level of lower quality "risk" asset prices. With global GDP growth slumping, and so much stress remaining in the world financial system, we believed that by now, "fractures" in the pricing of riskier assets might have emerged. Simply put, we didn't envision being correct in our assessment of sluggish economic activity, including a prolonged period of low interest rates, while misjudging the overall level of prices for more risk-based asset classes such as U.S. equities.

Now that we tested the theory that confession is good for the soul (but not good for the ego), we can proceed with our present view of the investment landscape. Quite often, market pundits begin their investment outlook by saying that the relationship between "such and such" (technical term) and Treasuries is a good relative value or not. So let's begin our discussion with the "thing" that people love to hate, U.S. Treasury Bonds.

The purpose of this musing is not to try to make the case that interest rates would be where they are today without Federal Reserve action. However, while all eyes are on the Fed, we need to be mindful that there are other natural secular forces at work serving to put downward pressure on the overall level of U.S. Treasury bond yields.

Some of these factors include:

- Notwithstanding the amount of new issue supply being purchased by the Federal Reserve (QE), the global pool of very high quality bonds is shrinking.
- The aging population of most developed nations may dictate a shift from equities to quality bonds as they approach retirement age. We know that there has been much talk of a shift the other way. In fact, the shift from bonds to stocks has been dubbed “The Great Rotation”, but there is still little evidence of its existence (like Big Foot).
- The continued slower level of economic activity should serve to keep rates lower, and for longer than most people think.

While we admit that no material fractures in the investment landscape have emerged, most would agree that the world is ripe for a “fat-tailed event” (i.e. extreme events are becoming more probable). Equally as important, the “world’s” ability to deal with another crisis has been weakened as a result of the increase in liquidity already created by global central banks.

Now that we have discussed the benchmark (U.S. Treasury yields) for which the relative attractiveness of many other asset classes are evaluated, let’s briefly discuss the pricing of four other investment alternatives: Corporate High Yield Debt, Equities, Commodities, and Gold (we separate Gold because so many refer to it as a separate asset class). While this portion of the commentary may be a tad more quantitative (math-ish) than usual, please bear with us.

We will address the **High Yield Sector** first since there are so many discussions regarding this asset class as investors reach for yield in a “zero bound” interest rate world. Currently, there is a fairly loud debate on whether “junk bonds” are expensive (rich), or if the “bull” will continue to run? One Fed Governor, Jeremy Stein, in a recent address, raised a warning flag regarding the high yield sector. In particular, he worried that we are in an environment where investors are “reaching for yield” at a time of record new corporate bond issuance, which he points out has historically preceded strong market downturns.

Traditionally, market participants compare the relative yields between Treasury bonds and High Yield (the yield “spread”) to determine whether that market is “rich” or “cheap”. A quick trip down memory lane tells us that the tightest spreads of 250 basis points were recorded both in 1999 and 2007.

**Are “Junk Bonds” Really Attractive?**

	<b>Benchmark</b> <b><u>Treasury Yield</u></b>	<b>“BB-rated”</b> <b><u>Corporate Yield</u></b>	<b>Yield</b> <b><u>Spread</u></b>
1999	5.35%	7.95%	+260 bps
2007	4.90%	6.60%	+170 bps
2013	0.85%	4.35%	+350 bps

Upon reviewing the chart above, there is a basic question that each investor should answer for him or herself. Is there more or less risk if you invest in a below investment grade bond paying 4.35% (yield spread of 350 basis points over Treasuries) in 2013, than there is if you purchase a High Yield bond paying 7.95% or 6.60% (yield spread of 260 or 170 basis points over Treasuries) in 1999 or 2007?

**We certainly believe there is.** Remember “fatter” stated coupon rates can serve to cover an escalation in the level of issuer defaults, while lower yields afford less “insulation” from such unwelcome events.

There is no doubt that each market cycle carries with it objective and subjective differences that can change the answer above, but we use the example only to point out a hidden risk. While the market talks about cheap valuation relative to the historic tight credit spreads, the reach for yield mentality in a zero bound interest rate market can create the illusion of “cheap”. In other words, there is a large chorus of investors who openly comment on how “ugly” and “unattractive” Treasury bond yields are, but then proceed to admire the attractiveness of another asset class based off of those “ugly” yields.

**Next, the second asset class: Equity Securities:** Of late, stocks were referred to as the place to be as the financial press fell in love with the term “The Great Rotation”. To support this bullish argument, an old tool, dubbed the “Fed Model”, has been brought back in to the spotlight. While we won’t bore you by turning this commentary into a “quant session”, the Fed Model concept examines the relationship between stock market dividend yields and US Treasury Bond yields. Simply put, the Fed Model compares the amount of earnings that one might expect to receive over the next 12 months if you purchase the S&P 500. If, the earnings yield (Earnings/S&P 500 price) is higher than the yield on the UST 10-year bond, then the equity market is said to be undervalued. Conversely so, (bond yields exceed the index) then the equity market may be considered overvalued.

The problem with this model is that it doesn’t seek to uncover whether the stock market is cheap or expensive based on its own merits. It is merely a relative analysis, and a crude way to analyze whether stocks are cheap or expensive relative to Treasury bonds. This may be another example of how zero bound interest rates can create the illusion of cheapness in other asset classes. Here’s how: It could be that the model indicates that the stock market is cheap, and therefore assume that it will rise. In actuality, this relative cheapness can still have the market priced to “absolutely” (not relatively) deliver well below average long run returns.

**We will only touch on Commodities briefly...**

We must admit that in many ways this is the most perplexing asset class, touted as one to be boosted by Fed liquidity. In recent history, commodities also tended to move in the same direction as equities, and often led the equity market up or down as indicators on the leading edge of economic strength or weakness. With Chinese and the U.S. economies touted to be gaining momentum, together with renewed U.S. housing strength, it appears an anomaly that copper, iron ore, aluminum, and lumber should be seeing such extraordinary current weakness.

Only two possibilities exist. The economies here, and in China:

- 1- are not as strong as the market believes, and may even be weakening, or
- 2- are stable and possibly accelerating, but that these specific commodity prices have already exceeded their sustainable levels.

**Gold as its own asset class**

Gold has been touted to be one of the most secure asset classes to own as long as central banks continue to print money, monetize their debt, and debase their currencies. Well, central banks are printing more currency than ever and yet gold, of late, is on a very serious price retreat.

Japan vows 2% inflation, Ben Bernanke has the spigot of dollars open with only the threat of turning the knob to the closed position, North Korea threatens South Korea, **and Gold can't "catch a bid"**. This may be yet another example of how normal market pricing assumptions fail to tell us if the price being assigned to that asset class is "fair" or "expensive".

Another example: recently Apple was the most loved stock in the galaxy, with a below market multiple, above average profit margins and more cash on its books than a medium-sized country. At one point, it seemed sure to go to \$1000 -- now \$500 seems difficult to achieve.

Where are we going with all of this? We are in a market where people line up to say how poorly priced Treasuries are, and then the next thing you hear them say is: "stocks are attractive", or "high yield is attractively priced versus Treasuries", or "gold is a good alternative".

**When assets appear attractive, mostly because the relative benchmark is so incredibly low, how do you make historic relative value comparisons???**

When almost everything is made to look "cheap" to Treasuries it becomes significantly harder to recognize bubbles. Everything that isn't a Treasury appears levitated to some extent. Eventually, the market will figure out which asset classes are levitated too far. In 1999 and 2000, we didn't know when or if the bubble would burst, but if it did we knew it would be in technology. In 2006, we knew that a bubble was soon to burst and that it would be housing. When a policy is

designed to inflate all risk assets, how do we recognize the bubble? It's easy to repeat the mantra that money printing raises the value of all risk assets. The question is, how do we know when these assets go beyond a level that even oceans of liquidity can't sustain?

As we wrote in the past, the Federal Reserve's "liquidity for all" policy should produce a variety of unintended economic and investment consequences. In this new era, it appears to us that individuals are talking about avoiding risk, but then embrace it because they feel that they have no acceptable alternative. Today's low yields have had the effect of dragging investors out on the risk curve in order to chase the prospect of a higher return. Many are deploying an "overweight" amount of monies in sectors they would previously have deemed to be unsafe, even before the financial crisis began. While we are not suggesting that investors adopt Grug's "Never leave the cave" policy, investors need to be cognizant, again, that this time is different. Have we ever seen \$3 trillion pumped into an economy? Have we ever seen the result of that liquidity pump to be 1.5% economic growth?

#### **Municipal Commentary**

In the low interest rate environment characteristic of the last few years, many investors chased yield. This strategy, to some extent, was supported by the expectation that "economic recovery" would lift all boats. Accordingly, credit spreads tightened to levels that, in our opinion, are extremely compressed. We suspect that this relationship will start to unwind as professional investors trade out of lower-rated investment grade credits in order to take profits and to improve portfolio credit quality. The weakness of the "present recovery" also supports the trade to higher credit quality. The following discussion provides snapshots of California, Illinois, and Puerto Rico – all lower quality investment grade credits.

#### **Weak Economic Prospects**

The White House projects economic growth to be 2.3% during 2013. We believe this will prove to be too optimistic, and we maintain our forecast for 2013 to be in the 0% to 2% range. To date, the Great Recession has been marked by the slowest recovery on record, while the equity markets enjoy easy money courtesy of the Federal Reserve.

While there has been some recovery in state revenues to date since mid 2010, we note that the quarterly year-over-year percentage increase change in such revenues declined dramatically during 2012 from the previous year, with the sole exception of the 4<sup>th</sup> quarter of 2012. That exception is significant because to a large degree it represents income accelerated and recognized in 2012 in response to the higher federal taxes mandated in 2013.

With state governments awaiting the collection of personal income taxes "PIT" in April (by far the largest month for such collections), it will be interesting to see if such revenues fail to materialize as budgeted to the extent that such income was recognized in 2012. This is especially relevant as state government's largest revenue sources are personal income taxes.

**Case In Point – California**

Much recent popular press noted the improvement in California's fiscal condition. While this is somewhat true, we note that with A1/A credit ratings, the state is the lowest rated state, with the sole exception of Illinois rated A2/A-. Aggressive expenditure reductions, and the recently enacted "temporary" sales tax and income tax increase on the wealthy residents, have brought some semblance of stability to CA. Nevertheless, concerns and risks remain.

The state's reliance on PIT revenues is one of the highest in the nation, with a "progressive bent" that puts an increasing burden on the state's wealthiest residents. Standard & Poor's notes that PIT accounted for 46% of state revenues in FY 2002. They project that dependency to grow to approximately two-thirds of general fund revenues during the current fiscal year, with the top 1% of filers paying just north of 40% of all PIT. Embedded in PIT revenues, especially for high net worth payers, are capital gains revenues that are extremely volatile and difficult to budget for. S&P notes that capital gains have been as much as 12% and as little as 3% of FY 2008 and FY 2010 general fund revenues respectively.

We also note that California's expenditure cuts in response to the Great Recession were enormous. The state just amended the rules of budget adoption that previously required 2/3<sup>rd</sup> of legislative approval to a simple majority. It is not wrong to assume that there will be significant political pressure to start restoring recession-induced expenditure reductions, especially for education. The relaxation of budget adoption, with one party dominating the legislature, will make it easier to potentially increase future spending.

We also note that the state's recent "temporary \$8 billion tax increase", for the most part, was allocated directly to the various school districts and community colleges. The state also needs and expects to pay off approximately \$30 billion of various internal and external deficit funding and borrowings through 2017. This need precludes the state from building up "rainy day reserves", and remains as a budgetary constraint.

**Looking at Illinois: Lowest Rated State and Negative Outlooks**

Just like California, Illinois enacted a temporary income tax increase. Nevertheless, the state still does not produce the revenues necessary to sustain mounting expenditure pressures. The unfunded pension liabilities remain, by far, the worst among all states. While recent passage of a pension reform package helps, it too will be subjected to various union supported legal challenges. The state's accounts payable burden, fostered by chronic payment deferrals to vendors and social service providers, remains a chronic issue.

**Puerto Rico at the Lowest Investment Grade – Positive Factors Are Hard to Find**

Similar to Illinois, Puerto Rico still carries negative outlooks in addition to recent downgrades. The commonwealth has been in recession since 2006 with little, if any, impetus for economic improvement over the near or intermediate horizon.



Deficit financing and debt restructurings, while providing temporary budgetary relief, have not produced structurally balanced budgets. Pension funding is the weakest when compared to the states, and growing at an alarming rate as a percentage of commonwealth expenditures.

**Stockton, CA Snapshot**

In April, a Federal bankruptcy judge approved Stockton’s bankruptcy filing. This case may or may not have broader ramifications for other distressed municipalities. Currently, Stockton continues to make obligated pension payments to CALPERs on behalf of employees and retirees, while defaulting on their various debt obligations.

The various municipal bond insurers that guaranteed Stockton debt service are making the argument that pension payments should also be subject to cuts under the Stockton bankruptcy. This is where the “rubber meets the road”, as the California state constitution upholds the sanctity of pension payments including cost of living allowances. The important question becomes: will or can a Federal bankruptcy judge successfully trump a “state constitutionally” protected contract and promise? That answer remains to be determined. The Federal judge cannot dictate the terms of a municipal bankruptcy settlement. In short, a window may or may not be opened that could result in legal challenges in the various states where constitutional protection is afforded to pension obligations.

Please see our report entitled “Stockton, Bankruptcy, and Pensions” dated 4/2/13 at [www.rswinvestments.com](http://www.rswinvestments.com) under “Crossing the Bridge” for additional remarks regarding this specific situation.

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