Past Performance Affects Future Returns (12/16/13)

- *"Bull markets love to climb a wall of worry", but does today's investment landscape resemble one where there is no worry?*
- *Yield: what everyone wants, but at what price? Is it cheap, rich, or fair value?*
- *The market gives you two choices: you can look like a "jackass" before the peak, or look like a "jackass" after the peak.*
- *Detroit, Puerto Rico, pension fights, legal challenges…much of this is "old hat" and has little ability to shape events in 2014.*
- *New issue volume in the tax-exempt market should be less than the projected amount of bonds scheduled to mature or be redeemed next year.*

The Year In Review:

It's that time of year again, and for us the moment of truth. As the year closes, it is time to take stock and compare our prognostications versus reality. As always, while it is fine to point out accurate forecasts, the failures are important too. While we do not chase failure at RSW, sometimes without it, there is no growth.

Winners

- Deflation remains in force.

The Federal Reserve's preferred measure of inflation, PCE (Personal Consumption Expenditures Index), continues to fall toward levels not seen since the Fed embarked on the QE experiment (2009).

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

First time payment defaulters (mostly non-rated or below investment grade) stood at 42 through October 31st , down from 105 for the full year of 2012.

"Tweener"

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

If we assume that the average estimate for Q4 2013 is correct, than the GDP growth rate for 2013 should approximate 2.15%, slightly exceeding the upper end of our range.

Loser

- 10-year U.S. Treasury bond yields could reach 2.25% should a spike occur, with the floor for yields being 1.10%.

Very wrong! Yields marched higher than our targeted level, and continued their ascent, touching a 3% during 2013.

Bernanke's Virtuous Circle

On numerous occasions, Ben Bernanke has made it clear what he hopes can be accomplished with Quantitative Easing (QE). The central bank buys Treasury bonds to suppress yields, thereby "forcing" investors to purchase riskier assets such as stocks and high yield corporate bonds. The undeclared goal is to get us to pay more than we otherwise would for risk assets, leading to a sense of enhanced wealth and ultimately increased consumer spending. The end game is to promote corporate health, resulting in increased employment, increased investment, and increasing personal incomes, in what he describes as a "virtuous circle".

Against this backdrop, professionals attempting to forecast the bond markets must understand not only the fundamentals of the global economy, inflation/deflation etc., but also the gravitational pull of risky assets. After all, if this temporary "new normal" fails before the wealth effect takes hold, then the foundation of the Fed's virtuous circle will weaken.

This commentary should come with a warning label: It is lengthier than most and it will be a bit more "mathy", but we ask you to bear with us. The reason is simple.

We are potentially at one of those rare market inflection points that merit special attention.

Bubbles and Bulls

With the prices of "risk assets" on a relentless march, it harkens back to a time when Greenspan used the term "irrational exuberance". Despite a constant barrage of "bubble talk" (an overused term), and the impending implosion of the equity and high yield bond markets, prices of assets continue to power ahead. Worrisome headlines such as those shown below have been commonplace:

> **Nobel Prize economist warns of U.S. stock market bubble**. *Reuters*
> **Is Fed inflating stock bubble?** *USA Today*
> **Bubble, Bubble, Toil and Trouble (For The Markets).** *Morningstar*

Opposing voices, and with equal volume, say that equity securities and to a lesser extent high yield corporate bonds, are the "only game in town". Optimistic headlines such as these serve to capture their views:

> **Why the NASDAQ is nowhere near a bubble.** *Yahoo Finance*
> **Former Fed Chairman Greenspan sees no bubble as DOW tops 16,000.** *Bloomberg*
> **Janet Yellen: No Equity Bubble, No Real Estate Bubble, And No QE Taper Yet.** *Forbes*

There is an old adage that says: "Bull markets love to climb a wall of worry", and climb they have! In fact, prices vaulted right over the "wall" constructed of QE taper, high unemployment, slow wage growth, slow retail spending, weak global economy, the falling dollar, and Congress. Again, "Bull markets love to climb a wall of worry" but does today's investment landscape resemble one where there is <u>no</u> worry? Don't think about that answer yet, as there is plenty of time for that.

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Junk but Not Trash

The purpose of this communication is to set out some objective mathematical facts of where we are historically on the "cheap"/ "rich" continuum. Since investing has such a big behavioral component, everyone who reads this will have their own reaction to the facts. Markets are about differences of opinion, and we at RSW have our own biases of what level of risk is appropriate today, and what price to pay for an asset.

Let's begin by discussing the taxable high yield bond market. To put this asset class into perspective two key variables are important. First, the average historical yield differential (credit quality spread) between "B" rated high yield corporate bonds (Merrill Lynch High Yield Mater Index) and Treasury bonds is around 593 basis points (5.93%). Presently spreads stand at 411 basis points (4.11%), only 170 basis points off the lowest levels recorded of 241 basis points. See the chart below displaying the path of the credit quality spreads since 1997.

The bullish argument contends that credit quality spreads are 170 basis points wider than the lowest levels seen, and that the default rate for high yield corporate bonds is below historical averages. The bearish argument remains that if the base rate (Treasury bonds) of the comparison is low, then the market should provide an above average credit quality spread. Furthermore, with the default rate being so low it is more likely to rise rather than fall further over time.

The simple question that investors need to ask themselves is: "Once we factor in an improved (lower default rate) environment, am I adequately compensated for the inevitable cyclicality inherent in the economy?" While we believe that the financial health of Corporate America is near biblical (technical term) proportions, we need to base investment decisions on sustainability. Earnings are 70% above historical averages (we will explore that later). Credit quality spreads are nearer to the tighter end of the spectrum, not the wider. Additionally, the default rate is significantly below historical average. We do not argue with the economic reality of "balance sheet nirvana", we only question its longevity. To that end, every investor should ask the following: *"Am I paying a price*

for high yield that assumes the continuation of an historical anomaly? And, how much deterioration in credit quality has to occur to see a meaningful widening in credit quality spreads?"

Eventually, the market provides its own answer, but we at RSW believe there is one thing that we can all agree on. Everyone needs yield!! Therefore, every investor should also be asking another question: "When everyone needs something in a market, what are the chances that the market provides it at a cheap price -- or even at a fair price?" To that point, if the prices were cheap why are issuers falling all over themselves to issue high yield bonds? Year-to-date 2013, total sales of high yield (junk bond) debt climbed to a record high of $339 billion.

Now, let's view the attractiveness of the high yield taxable market by comparing "junk" bonds to the yields offered on "AA" rated tax free municipal bonds. You are free to proceed with the "spitballs" for touting the municipal asset class, but we do it for a specific reason, not a sales pitch. There is no better vehicle to use than tax-exempt bonds to demonstrate the NET "in your pocket risk premium" that individuals are willing to accept when purchasing high yield bonds. Perhaps, the best way is to look at the "after-tax" returns of both asset classes. The following example assumes two scenarios. The first is that investors are subject to the "full freight" of federal income taxes, comprising a base maximum rate of 39.6% plus 3.8% levied for the Medicare tax on unearned income (total of 43.4%). The second assumes you get a break, and with some "offsets" the "Tax Man" only keeps 30% of your money. To illustrate our point, we will use the Merrill Lynch High Yield "B" and "BB" rated Indices for yield comparisons.

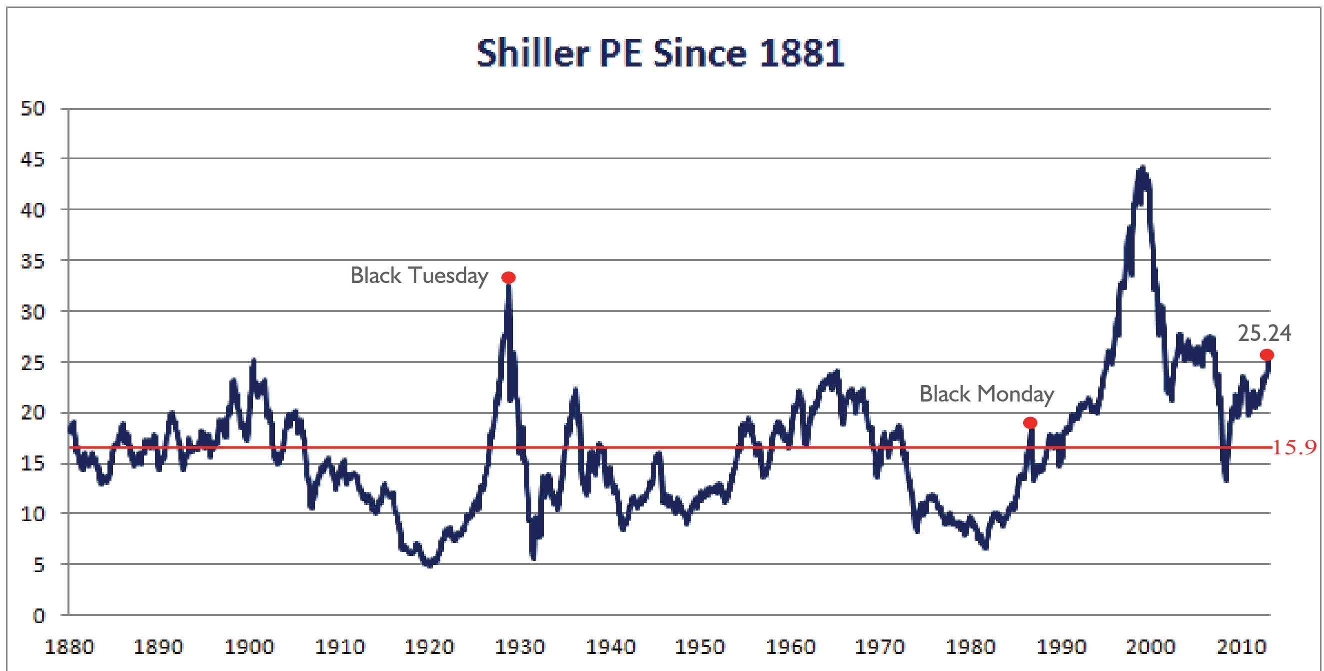
	"B" Index	"BB" Index
Average Maturity	13 Years	12 Years
Gross Yield	7.15%	6.80%
Net Yield (After 43.4% Rate)	4.05%	3.95%
Net Yield (After Hypothetical 30% Rate)	5.00%	4.76%

	13-Year "AA" Municipal Bond	12-Year "AA" Municipal Bond
Tax-Exempt Municipal Bond Yield	3.28%	3.15%

Whether we use the 43.4% total tax or our hypothetical 30% rate, the reward of high yield bonds seems to be negligible considering the risks. While it is understandable that some may dismiss this analysis as a municipal guy trying to "talk his book", but here again, with history as a guide, we need to ask ourselves if we are being adequately rewarded, i.e. 75 to 170 basis points to own a "B" corporate bond rather than a "AA" tax free municipal bond? Do we maintain maximum exposure to an asset class of historically low rates, well below historical average credit quality spreads, below average default rates, and record levels of new issuance? That feels like investing on what has already occurred, not what lies ahead.

Stock Returns: Shock and Awe

Next, let's go where the "bubble talk" is the loudest, the equity market. No, there will be no municipal bond comparisons here! As many of us know, there are many matrices available to demonstrate the "richness" or "cheapness" of the stock market. The one that we will illustrate here is the Shiller PE ratio (Price/Earnings).This system is methodical, as it is designed to smooth out both high and low earnings periods by U.S. corporations. In its simplest form, the ratio is calculated by dividing the 10-year average of inflation-adjusted earnings by the current price of the S&P index. Below is a chart (http://www.multpl.com/shiller-pe/) detailing the path of Shiller PE ratios over the last 132 years.



As you will note from the work above, there have been only two instances where the PE ratio exceeded today's level of 25.24; the tech bubble (44.2 PE) and Black Tuesday 1929 (32.6 PE). Additionally, we are interested in the study because of its predictive power of future stock market returns, but we will discuss that later. While it seems fair to say that virtually every investor believes in the general concept of reversion to the mean (FYI, the long term median (shown in red above) for the Shiller PE stands at 15.90), it always seems that whenever you are in a major bull or bear market, investors seem to lose confidence that the market will ever revert. They take out their ruler, and draw a straight line as if the trend will continue in perpetuity. Perhaps, now is a good example of such a time.

Clifford Asness, founder of AQR Capital Management (one of the most respected quantitative money managers), wrote a research report explaining why the Shiller PE was both relevant and a useful investment tool. While admitting no measuring stick is perfect, even over decades, he effectively refutes attacks that claim in so many ways that "this time is different". While he admits it should never be used as a market timing tool, he contends unless you think that there has been some fundamental or structural change in the market that will affect future returns he

still considers it a useful tool in setting forward expectations. For example, he analyzed data from 1926, and noted that if you deploy assets in the S&P at a time when the Shiller PE ratio fell within certain bands you can expect a certain return over the ensuing decade. Below is an accounting of this study which displays the *average*, *best, and worst stock market returns* for a given level of PE. Again, today the Shiller PE stands at 25.24.

Starting PE		S&P Total Rate of Return			Standard Deviation
Low	High	Avg 10 Yr	Worst 10 Yr	Best 10 Yr	
17.3	18.9	5.3%	-3.9%	13.8%	5.1%
18.9	21.1	3.9%	-3.2%	9.9%	3.9%
21.1	25.1	0.9%	-4.4%	8.3%	3.8%
25.1	46.1	0.5%	-6.1%	6.3%	3.6%

This analysis does not say anything radical; it simply quantifies what all investment professionals already know. ***Outsized current returns borrow from future returns, and all that remains to ascertain is when those returns begin to revert to the mean. We recognize this is easier to write about than implement.***

There is another quieter debate concerning market valuation that has gone on in a stealth-like manner concerning the "E" portion (Earnings) of the PE's. As we mentioned earlier, currently, corporate earnings are 70% above historical averages. If history repeats, it implies earnings will retreat back to the mean over time. Warren Buffet voiced an opinion on this subject and said: "In my opinion, you have to be wildly optimistic to believe that corporate profits as a percentage of GDP can, for any sustained period hold much above 6%". Today, that percentage now equals 12% of GDP.

This is an important concept. Remember, the Shiller PE is already flashing a strong warning signal, but if earnings retreat from current levels, then the Shiller PE will move even further into dangerous territory. Earnings are the denominator of the Price divided by Earnings equation. Again, this analysis is not intended for "shock and awe" purposes, but instead our intention is to give an honest assessment of our location on the value of the risk-to-reward spectrum. Rather than assign labels to prices, such as "bubble" (seems like an overused term and who knows what the true definition is), it is also fair to say that if you allow for some earnings reversion it is hard to classify the equity markets as "fairly priced". The only way we can get there is to use the period of the technology bubble as a benchmark, and take solace in the fact that we are not that "rich".

For those who like more data rather than less, as promised, we will offer a cross section of market matrices. Back in August, we saw a report from Barclays giving their assessment of the market. We will use their numbers from August 12, 2013 and update the figures using current data. See below.

S&P Valuation	8/12/13	Current	Mean
Price / Sales	1.5X	1.62X	0.8X
Price / Book Value	2.4X	2.64X	1.90X
Price / Trailing Earnings	17.9X	19.76X	15.0X
Price / Forward Earnings	14.2X	15.3X	11.6X

As you will note, the statistical data calculated in August showed the ratios well above the mean, and now they are richer still. "Rich" can get "richer", and "cheap" can get "cheaper". As always, it is difficult to know when to pare back risk just because the levels seem to be unsustainable. Just ask the owners of gold or other commodity traders.

As a risk assessor, do we feel that someone should have the same level of risk on today as they did 6 or 12 months ago? -- the simple answer is no. Anyone who has the slightest belief in reversion to the mean should be paring back risk exposure. We make no trading judgment about tomorrow or next week, but pointing out our present position in the scope of history is a necessity, or said differently it is called "portfolio management". If you simply broaden the concept of "Dogs of the Dow" to other asset classes the concept becomes clear. Outperformers get trimmed, and underperformers get added. So selling some Amazon to buy gold or copper is not a "left field" concept.

In each of our roles as managers or asset allocators, we are obliged to think with the brain of a trader and an investor. Each will weigh those two functions differently or at least differently at various times. The trader in us wants to stay with what's working, while the investor in us should at least ponder the question whether it is safe to assume that it keeps working. What is safer: an 8% "B" rated bond priced at par, or Apple? The correct answer is we don't know until you fill in what price we are paying for Apple. If you called someone when Apple was trading at $690, and that person answered Apple, they would be terribly wrong, at least from a performance point of view.

We read Bill Gross' Investment Letter this past week and something he said jumped out. Specifically, he said that the Fed, BOJ, the ECB, and BOE are basically telling investors that they have no alternative other than to invest in riskier assets or to lever (borrow money to purchase) quality assets. "You have no other choice" he went on to say. But he missed a third choice that the market has obviously made, investors are leveraging risky assets. In fact, margin debt just hit a record high, topping $400 billion. Just look at the previous margin peaks. The crowd typically doesn't lever risk when it's "cheap", they do it when it's "rich". At the end of the day, an increase in margin debt (borrowing money to buy stocks) is really a reflection of investor sentiment. As equity prices move higher, investor confidence escalates and investors seek to capitalize on the strong market conditions by borrowing monies to invest.

Does It Get Any Better Than This?

Over the last several years the taxable high yield (junk bond) market has provided fantastic returns -- while nothing compares to equities. The reality is that the majority of those returns were realized not by bond coupon income, but instead by credit quality spreads moving to low levels rarely witnessed before. To continue to maintain the same position in this asset class, you are in essence "betting" that the spread will be maintained, or move lower over the life of the investment. It can happen, but investors should invest on probabilities, not on the best case possible. Much of the same thought process can be said about the equity markets, with a couple of distinctions. Nothing has come close to equity returns, and the loudest chorus says it is the "place to be" or it is "the only game in town". And then there is a bubble chorus.

This commentary is not designed to send you running away screaming from the equity markets or high yield bonds. Nor however, do the numbers suggest that they are trading anywhere near "fair value". You can see for yourself where we are historically, with or without a mean reversion in earnings. These communications are

designed to get us all to think. So much about investing is behavioral. Some people prefer to lighten positions as things in their minds become mispriced, while others would lose sleep if they sold one position in a rising market.

One old street adage remains true. The market gives you two choices: you can look like a "jackass" before the peak or look like a "jackass" after the peak. As you have already imagined, our bias is to lighten up as markets extend if for no other reason than you dictate the price and how much. On the way down, the market can dictate how much and at what price.

For brevity's sake (trying!), we intentionally avoided a discussion of gold, commodities, and emerging markets. This is clearly a time however, when any asset that has traveled well past its historic mean, above or below, deserves a look. Just as an example, since at least 2000, there has been a strong correlation between equities and commodities. That correlation has totally broken down. Investors should at least ask the question whether the relationship has changed long term, or whether one is going to catch up with the other. Similarly, gold was the asset class of choice for years and accelerated "as long as Central Bankers" were printing money. Markets are designed to present different choices, but that can be translated as opportunities. What seems logical or easy for one investor could be impossible for another. Simply put, every investor needs to decide if recent or *past* performance colors their thinking about the *present* pricing of an asset and their assessment of *future* returns.

A Preview of 2014

The Outlook for Treasury Bonds, Economy, and Inflation

It appears that many pundits have already reached a conclusion that the bond bull market is over, and that 10-year maturity Treasury bond yields are poised to rise for years to come. At RSW, we remain convinced that the fundamental economic backdrop does not warrant a long term "bear market" in bonds. Although we will fully cover our thoughts about the economy, inflation etc. in RSW's Q4 2013 Commentary (released the second week of January), the bottom line is that current economic conditions remain sluggish. Highlights include:

- The shrinking labor participation rate (now 63%, lowest since 1978) is forcing the unemployment rate lower as a result of individuals dropping out of the workforce.
- Wage growth remains tepid. Nominal earnings over the last 12 months have only grown at a rate of 2.3% or 1.6% after inflation.
- Consumer spending remains well below trend and has averaged 2.2% over the last 17 quarters.
- The Federal Reserve's preferred measure of inflation PCE (Personal Consumption Expenditures Index) continues to fall toward levels not seen since the Fed embarked on the QE experiment (2009).
- In 2014, inflation should continue to fall as consumers spending shrinks.
- RSW's base case is for GDP to continue to grow in the range of zero to two percent.
- Should yields rise next year, we believe that 10-year U.S. Treasury bond yields should crest at 3.40%. As you will note below, this level marks the top of the downward sloping trend line that has served to cap rates for more than 28 years.

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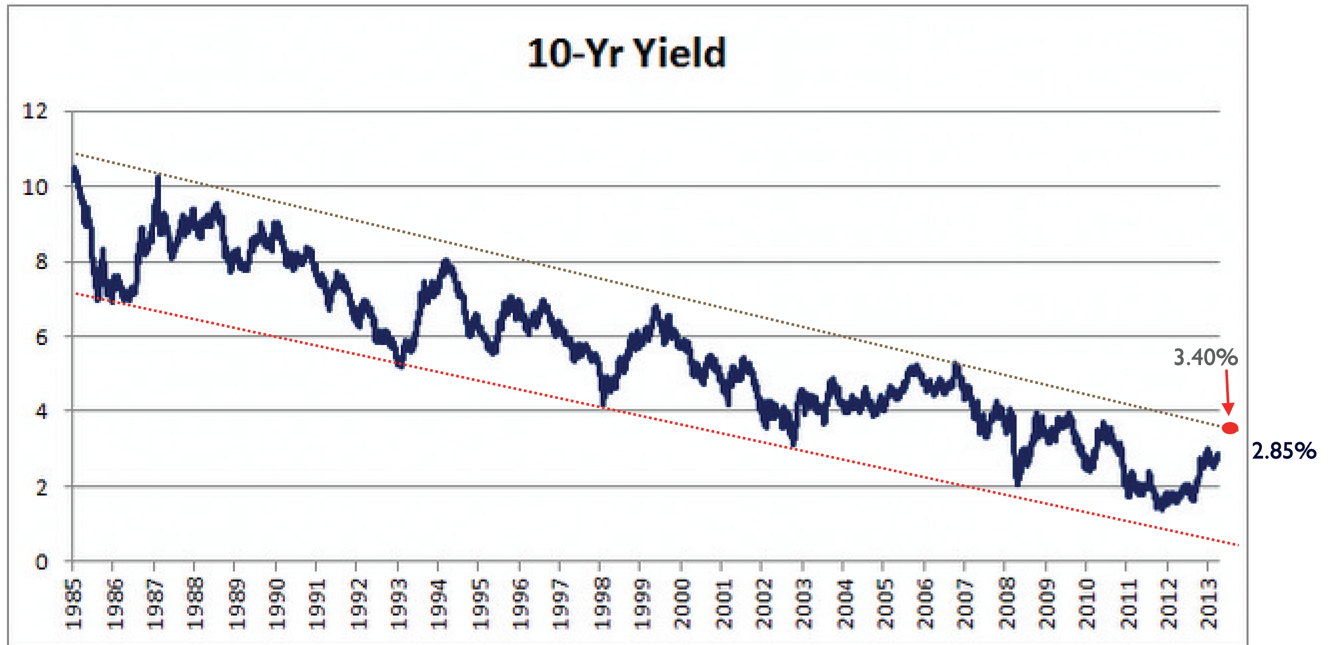

- Should 10 year Treasury bond yields rise above this line (3.40%), the trader in us would be concerned, and we would consider abandoning our "low interest rate environment call".
- The portfolio manager part of us, would understand that economies do not function on chart points. It has been a long held view of ours that interest rates are themselves "self-breaking mechanisms". Given the fragility of the economic recovery, it remains our view that a sustained period of higher interest rates should only serve as a meaningful impediment to a more normalized growth rate. This, in turn, puts downward pressure on rates.
- For example, this line was broken in the second quarter of 2007 (see RSW's Q2 2007 Market Commentary). In that report, we were confident that the breach of this trend line was not permanent and we held to our low inflation, low rate call.

Municipal Bonds
Looking Ahead in 2014: The Real Headlines are Behind the Front Lines

It is really no secret that Detroit, Puerto Rico and the pension fights and legal challenges in Chicago and Illinois will continue to provide more than their share of headlines in 2014. However, much of this news is "old hat", and has little ability to ultimately shape muni events in 2014.

The real story is behind the scenes, and what we believe will be the relative short supply to demand for quality investment grade municipal bonds in 2014. This scarcity should be especially acute early in 2014 (January through February), during the summer months and at year-end.

The reason for this is as follows:

- We fully anticipate a sharp decline in new issue volume during the course of the year.
    - The low rate environment of the past few years induced a surge in refunding volume to record levels. We would not be surprised if such activity fell by as much as $100 billion during the course of 2014.
    - New money financings should also decline, as governments take a conservative posture in order to improve their balance sheets with many immediate needs already fulfilled during the previous record low interest rate environment.
    - We would, therefore, predict primary muni market volume for 2014 to range from as low as $260 billion to $300 billion, as compared to 2013 estimated volume of $315 billion.
- The real story however, is that 2014 new issue volume, whether on the high or low side of the estimate, will be less than the projected par amount of bonds scheduled to mature or projected to be called (redemptions). It would not be unreasonable to see new issue supply, net of redemptions at a ***negative*** $20 to $60 billion.
- These "technical factors" should continue to provide support to the municipal market, especially in the shorter and intermediate parts of the curve - as most pundits anticipate a shift to higher interest rates during the later course of 2014.
- Throughout 2013, the municipal yield curve has been "steepening", with market yields on 5-year maturity bonds holding relatively steady, while longer-maturity yields have risen more rapidly.
- For example, today, investors can collect a 150 basis point annual yield advantage by purchasing a 10-year "AAA"-rated municipal bond at 2.66%, versus the 1.16% yield afforded by a comparable quality 5-year bond.
- Over the last 25 years, this historical "spread" was as narrow as 12 basis points (0.12%), and as wide as 158 basis points (1.58%).
- We expect this yield gap in the tax-exempt market to begin to close in 2014, thereby enhancing the relative performance of RSW's portfolios. Our team traditionally avoids shorter-dated maturity bonds.

Keeping an Eye on Credit Issues in 2014

- The Detroit bankruptcy will run its course with minimal impact on the general market.
- Puerto Rico will continue to produce weak headlines despite various small positive measures. Market access will continue to be a hardship. Junk bond status is a real possibility.
- Chicago pension woes will continue to generate headlines, as will the legal challenges to the Illinois pension deal.
- The muni market will look to see how the newly elected Mayor DiBlasio of New York City will negotiate with the city's unions who are looking for 3 years of retroactive salary increases in the neighborhood of $8 billion.
- While California has reversed its red ink, the real issue will be the election year legislature and the pressure upon them to restore draconian cuts and to build up depleted reserves.

Headlines Create Opportunities

If headlines about Puerto Rico, Detroit, and Chicago affect high quality municipal bond yields, we would view it as an opportunity, just as if a Blackberry bankruptcy effects the pricing of Apple.

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