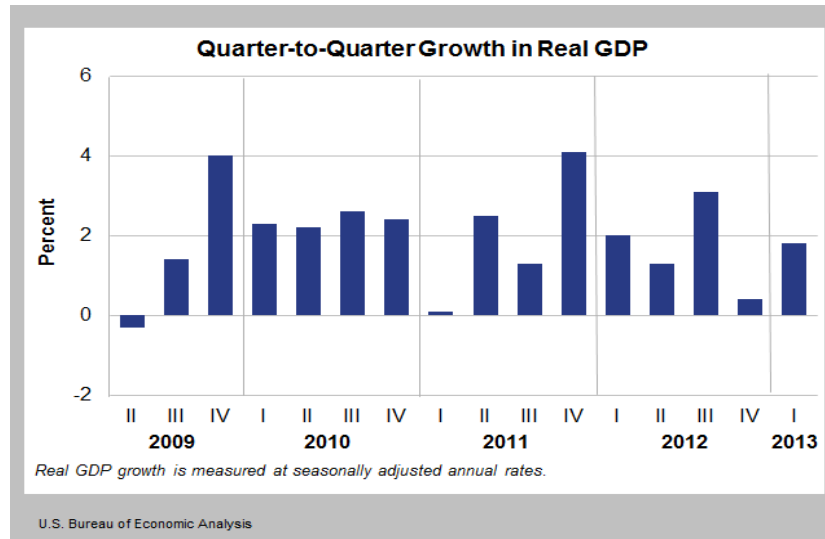


Premise or Market Price: Which One's Wrong? (7/8/13)

So when we look in the mirror, where does the soul searching regarding recent market declines take us? It takes us to probably the most consistent theme of our economic outlook of the last six years. Extremely low rates are not just nice to have, they are an absolute necessity for a fragile, and now decelerating, world economy.

By now, we have all heard several lengthy explanations of the recent pervasive and violent downdraft that shook all asset classes around the world. Emerging markets, gold, commodities, equities, and bonds of all descriptions suffered differing degrees of illiquidity, not seen since 2010. Money managers were each engaged in their own "mea culpas" as to why their asset class didn't perform as well as might be expected. RSW won't dodge any "unpleasantries", including the municipal asset class' rare underperformance during a period of rising interest rates. Although we had projected a temporary period of rising interest rates that would take Treasury bond yields up from 1.65% to 2.25%, we simply did not envision the "overshoot" that would take yields back to 2.75%. With that said, the question we should all be asking ourselves is: "Has the economic landscape (inflation, employment, interest rates) changed enough to warrant a change in opinion regarding investment philosophy?"

Since Federal Reserve Chairman Ben Bernanke can be credited with sparking the most recent market "sell-off", let's begin there. Bernanke reported that the Federal Reserve expects to begin to "taper" its purchases of U.S. Treasury and mortgage-backed securities if the U.S. economy strengthens in the second half of this year, and approaches a growth rate of 3%. Moreover, the Fed expects unemployment to decline to 7% this year, and eventually reach 6.5% by next year. Lastly, they believe that the forces that caused inflation to fall to 1% are temporary (not structural) and will eventually dissipate, bringing inflation back up to their 2% target rate. Given our perspective and interpretation of the data, we respectfully disagree. For years, Fed forecasts have been too buoyant, and this time should prove to be no different. Even the word "taper" is a misnomer in the sense that declining amounts of securities purchased will better match future declining U.S. Treasury bond supply due to the now shrinking federal deficit. Over the life span of various QE's, we were treated to a plethora of optimistic sounding terms by pundits regarding economic growth including: "the U.S. growth rate is reaching escape velocity", "self-sustaining recovery", "economic numbers are better than expected" (this phrase has replaced the old fashioned term of "good" economic numbers), and finally, "an economy that is ready to stand on its own". So when you put \$3.5 trillion on the Fed's balance sheet by purchasing U.S. Treasury and mortgage-backed securities, and you add up all of the hits (car sales, housing) and misses (income growth, total employment) that the various economic numbers currently have to offer, here is what it looks like in its most comprehensive measurement:



Please forgive the sarcasm, as you glance at the chart above, does that look like an economy that is ready to roll without training wheels? Does the level of growth look like it no longer needs the supporting hand of the Federal Reserve?

In late 2010, RSW forecasted that the pace of GDP would be “stuck in the mud” with economic activity growing at a rate below 2%. To offer some perspective, from 1947 until 2013, the United States GDP growth rate averaged 3.2%. Now, after four years and \$3.5 trillion dollars added to the Federal Reserve’s balance sheet, we have grown at an average rate of 1.8% and GDP is expected to slow from there in the Q2 of 2013. Additionally, by looking at the chart, you will note that since 2011 each peak level in growth has been lower than the previous peak, and secondly, that economic activity is currently decelerating, not accelerating.

Looking at the world today, it seems that the views of market participants can be distilled into two schools of thought. If you believe that the extraordinary policies of the world central banks can operate in perpetuity, and that they can at least partially solve underlying economic problems, you have one view of the world. If, on the other hand, you still view debt as our central problem, and what we have gotten after the “debt crisis” is more debt, structural unemployment, and wage stagnation, then you have a different view. We probably all have some preconceived notions, but our job is to have an open discussion. We do freely admit that we have doubted the “accelerating growth” story because the facts do not support it.

That brings us to last Friday’s employment data. By now, we are sure that everyone has heard about the strength of the much anticipated “jobs report”. Let us begin by looking at the headline number, nonfarm payrolls (NFP). According to

the Bureau of Labor Statistics (BLS), the economy added a healthy 195,000 jobs. Moreover, the report contained upward revisions to April and May, which showed an additional 70,000 individuals gaining employment.

The portion of the report that is not well “advertised” is the 322,000 “part-time workers” included in the NFP report. These individuals were working part-time because their hours had been cut back, or because they were unable to find a full-time job. In addition, voluntary part-time jobs increased by another 110,000. Thus, of the 195,000 total non-farm payroll jobs created, 432,000 (voluntary + involuntary) of them were part-time jobs, as well as the loss of 237,000 full-time jobs (432,000-195,000). This result caused a spike of 0.5 percentage points in U6 (unemployed plus underemployed) to 14.3%, a four month high.

Another way to describe the anemic employment picture is to reflect upon the facts stated in RSW’s Q3 2012 Newsletter entitled “Infinity and a Day”.

As you may recall, we said:

Since the Great Recession began:

- 60% of the jobs lost were medium paying (\$13.84 - \$21.13 per hour).

During the Recovery phase:

- 58% of the jobs created were low paying (\$7.69 – \$13.83 per hour).

The Trend Continues...

If we were to examine the last two months of jobs reports, we will note that the current data is a microcosm of what we have often discussed. For example:

- A total of 390,000 jobs were created.
 - ✓ 118,000 were in the leisure and travel sector; average pay of \$11.76 per hour.
 - ✓ 64,000 were in the retail sector; average pay of \$13.92 per hour.
- These two sectors alone accounted for roughly 47% of the jobs created.

While we should all rejoice when anyone finds a job, we as a society should not be happy to see the unemployment rate decline from its peak of 10% to 7.6% on the backs of a lower paid workforce. This underscores our position when we say that the problem that we face as a nation is structural, not cyclical. The Federal Reserve is struggling to use coarse tools to create jobs and they most certainly do not have the ability to dictate the kind of jobs that are created. As mentioned above, if 432,000 part-time jobs are created and 237,000 full-time jobs are lost, the market rejoices over a positive headcount. Most would agree however, that this does little to add to our country’s overall economic health.

Some of these thoughts were summarized in RSW’s 2012 Outlook entitled: “Mind the Left Hand Drive” where we stated the following: “We believe there will continue to be periods of fear followed by periods of relative euphoria. Looking ahead, we do not see our central tenant -- that has been in force for the last several years -- changing...The underlying disease of worldwide structural unemployment, declining middle class wages, growing social unrest, and the unsustainable debt burden of most of the developed world, may collectively cap the level of future economic activity.”

Now let’s see how these economic circumstances translate into employment and growth statistics for the period 2011-2013:

| Year | Average Jobs Per Month | Strongest Three Months of Job Gains | Rate of GDP (Annualized) |
|------|------------------------|-------------------------------------|--------------------------|
| 2011 | 175,000 | 235,000 | 2.00% |
| 2012 | 183,000 | 262,000 | 1.70% |
| 2013 | 202,000 | 224,000 | *1.70% |

** Includes Bloomberg average estimate for Q2 2013*

Our conclusions:

- There is nothing new here.
- Job growth is modest at best, but the trend has been improving.
- Correlation between job growth and GDP is weak.
- After periods where the strongest payroll gains are reported, the economic activity tends to revert back to the weak underlying trend.

Periodically, we in the financial world are duty bound to engage in some extraordinary introspection of our belief sets. As you see above, we have attempted to question our fundamental premises with statistical objectivity. While it sounds boastful, it is fair to say our view of many economic matrixes has been more accurate than the Fed -- who has consistently overestimated economic strength.

So when we look in the mirror, where does the soul searching regarding recent market declines take us? It takes us to probably the most consistent theme of our economic outlook of the last five years. Extremely low rates are not just nice to have, they are an absolute necessity for a fragile, and now decelerating, world economy.

- Did rates rapidly exceed where we thought they could go? Absolutely!
- If we called for a yield rise to 2.25%, does a 2.73% make us wrong? Absolutely!

However, this is only a reflection of our ability to call the top of what we believe to be a cyclical yield rise, not our premise!

In RSW's Q1 2010 commentary we stated: "worries about surging bond yields traditionally crop-up when the economy is surging and financial conditions are favorable. In fact, many would deduce that this is an indication that we are back to business as usual. Yet, we at RSW believe that it is a mistake to reach such a conclusion."

If we felt any significant rate rise would injure the economy you should expect us to be more negative on economic activity with a larger and more sudden rate rise. Having your target exceeded may shake your trading confidence, but it should actually enhance your investment confidence. If higher rates hurt, higher still, should kill.

When any of us has a period where we perform up to our own expectations, there is a tendency to begin to shy away from giving outside of consensus views. There is no value added in that. Being consistent is not necessarily stubborn. Staying thoughtful and opportunistic after a market catches you wrong-footed is mandatory for long term success. Sometimes your fundamental outlook is wrong, and poor decisions can evolve from that. Other times your outlook is correct and the market is wrong. Just ask Apple or gold. And sometimes, even the bond market overreacts and gets it wrong.

As we stated in an Intra-quarterly commentary on January 19th, 2011 entitled "Is Perception Reality": "While no one has a crystal ball to know when the selling pressure will abate, some investors may be giving the market too much credit at predicting future events. Sometimes the price volatility is just what it seems as in this case. Too many forced sellers trying to fit through a tiny door at the same time".

In conclusion, we would like to leave you with a question and an observation.

- Are we at RSW trying to defend an asset class, or just calling them as we see them? We have long held the view that GDP growth would not exceed 2%. It hasn't! We said that inflation was on the decline (deflation). It is! We have held the view that all of the Fed's policies wouldn't stimulate growth back to trend levels (3%). It hasn't! When the Fed was purchasing \$50-\$85 billion per month of Treasury and mortgage-backed bonds and attempting to maintain 10-year Treasury yields below 2%, the U.S. economy mustered a GDP growth rate between 1.5% and 2%. With the Fed's tapering, combined with interest rates moving quickly to 2.75%, are we supposed to believe that an already fragile economy can withstand such a move???
- Looking back over the last 25 years, there were many other periods of tumult in the municipal bond market that proved to be fleeting. We have endured bankruptcy fears (ala Meredith Whitney), pension issues, flat tax scares, panic over runaway inflation, and angst over stronger economic data. In the end, when the fear dissipates, the market is left only with what is, not with what was anticipated.



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