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RSW's Q1 2017 Fixed Income Newsletter

When Worlds Collide

Municipal Bond Commentary

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When Worlds Collide

There were two things RSW took away from the failure to pass an ACA ("ObamaCare") replacement bill. First, Washington produced a credible remake of "Keystone Cops"; second was the market's ability to shrug off the repeal and replace debacle. Regardless of setbacks, the powerful perception of a shift to higher growth and reflation (higher inflation), could be an example where investor sentiment "Trumps" reality. While serious financial harm can result from standing in front of the sentiment train, boarding the train as it travels further away from economic reality can also be painful. It is too early to judge whether the President ultimately succeeds in his mission to repeal and replace the ACA and enact tax and infrastructure policies. It is not too early however, to observe that the bond market has placed a significant deposit (higher yields) on his ability to do so. Nor is it premature to say that it will be more complex and difficult to do so procedurally, politically, and mathematically than markets presently understand.

This qualifies as political risk

So now that repeal and replace has failed, we can go directly to tax reform, advance to "GO" and collect $200, right? Well no. The first order of business is to craft a bill by April 28th raising the debt ceiling, allowing the Treasury to issue debt to pay its bills. In the past, some of the collisions over raising the debt ceiling have been legendary, including threatened and actual government shutdowns. When we hear comments like "we'll now tackle tax reform", it reveals a misunderstanding of how Washington works, or doesn't. Pundits of all stripes are virtually unanimous that tax reform can only pass using a procedure termed reconciliation. It enables a bill to pass in the Senate with a simple majority of 51 members instead of the usual 60. OK, that's enough Washington speak, the English version starts here. Reconciliation limits how long Congressional members can throw mud at each other to a maximum of 20 hours, instead of the preferred unlimited mudslinging (termed a filibuster) which effectively sinks the legislation. One of the requirements for the reconciliation's use however, is that the legislation will not add to the deficit over the next ten years (revenue neutral), and claim it with a straight face.

After the bill is passed to raise the debt ceiling, but before tax reform is undertaken, Congress must debate and adopt a budget projected to be taken up in May or June. Upon the successful birth of a budget, reconciliation instructions are sent to the tax-writing committees. Now assuming that enough mud has been thrown and has sufficiently hardened, lawmakers should be ready to address tax reform. This is where the failure to repeal the ACA complicates their efforts. Remember the 3.8% ObamaCare Net Investment Income Tax?

This piece of legislation was estimated to bring in about $1 trillion in revenue over 10 years in various taxes and fees. Lawmakers needed to "lose" those revenues in the repeal bill because doing so creates a lower hurdle to clear when claiming that the tax reform bill was revenue neutral. Let's explain. It is anticipated that the implementation of the tax reform proposal would reduce revenue over a 10 year period by $2 trillion. So, if for example lawmakers start with $9 trillion in revenues instead of $10 trillion, Congress would only have to find $1trillion in new revenues instead of $2 trillion (you can't make this stuff up!). Whatever one's assessment of the probability of tax reform, it is now $1 trillion more difficult.

The last and hands-down most controversial piece of tax reform is the border adjustment tax (BAT). This proposed plan alters the way in which businesses are taxed in the United States by shifting the current corporate income tax into a "destination-based cash-flow tax" (DBCFT). English version: While the plan is complex, a central tenet is that to support U.S. based corporations, it would tax imports and exempt exports from the levy.

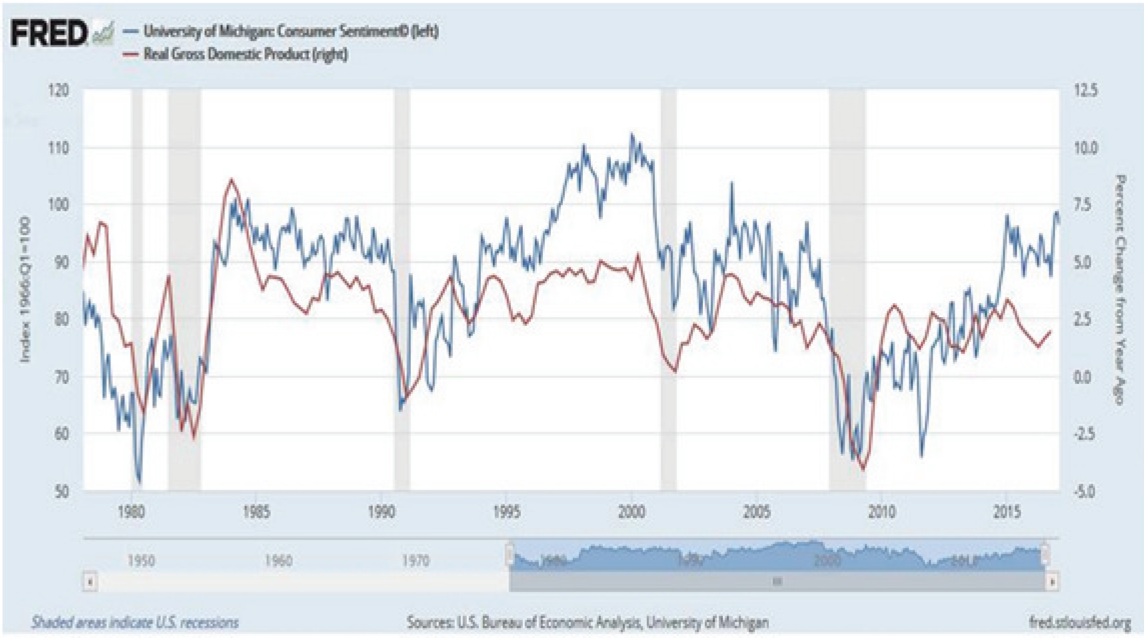
The list of objections and those objecting is lengthy, but its main drawback is that it may create as many losers as winners. Large retail companies such as Wal-Mart have begun lobbying in earnest against it, but many smaller retailers will also be negatively impacted. The World Trade Organization (WTO) claims the tax would violate its rules and vows to challenge its legality. Remember, this tax is needed as the main revenue source to offset the revenue lost from tax cuts, and became more crucial with the failure to repeal the ACA.

While interesting to some, we don't enjoy pontificating about Washington's mental gymnastics. However, please remain mindful of a couple of RSW's strong convictions:

- The foot race is over! The financial markets are speculating that President Trump's pro growth policies would escalate the pace of economic activity before higher yields born from those expectations eroded the pace of economic activity. As we have said in the past, it normally takes three to six months before a yield change of 40-50% (10 year yields rose 42% to the high yield of 2.64% since the election) before a noticeable slowdown in inflation and GDP is visible. That time is now! First quarter 2017 GDP estimate from the Atlanta Fed now stands at 1.2%

- There is enormous momentum behind the concept of "reflation", but also a lopsided bet on the certainty of the success of the administration's policies. The level of conviction is so strong that we believe the fixed income markets may still be underestimating the difficulty in enacting the sought after reforms.

Perhaps this asymmetrical market view can best be summarized by a historical comparison of the University of Michigan Consumer Confidence Index and the pace of GDP. The chart below details the relationship of Consumer Sentiment (shown in blue) with the annualized real GDP (after inflation) rate (shown in red).



Two takeaways are important. First, it appears that once the sentiment index nears an extreme, the pace of economic activity is set to "roll over". Second, as the gap between confidence and GDP balloons, it precedes a meaningful slowdown in economic activity. While it is hard to know whether this chasm of difference between the data sets is at a peak, it is clear that the two measurements should converge with actual growth rising toward sentiment, sentiment falling toward actual growth, or a combination of both.

Historically speaking, the powerful forces of deflation caused by the structural forces often cited herein have been challenged by every conceivable policy before. Policy has won some rounds, but not the fight. Crediting these plans with more effect than they may actually have and making a large down payment for their success, can lead to disappointment. Many erroneously believe our recent sub- 2% growth is an outgrowth of the Great Recession as opposed to a continuation pattern of the last 50 or 60 years. We believe what has come to be called "the new normal" is older than you think, and if there is a further spike to higher rates, they should only prove to be unsustainable and self extinguishing.

As asset allocators and money managers we all need to handicap the probability of outcomes and act accordingly. We encourage our readers to assess our conclusions and ask themselves if they are incorporated into their market opinion and actions.

Municipal Bond Commentary

The municipal bond market regained its footing during the 1st Quarter generating relatively strong results after a very difficult fourth quarter 2016. This was reflected in the total rate of return of the Barclays Capital Municipal Bond Market Index which posted a return of 1.58%. As expected, selling pressure abated led by a turnaround in mutual fund flows which turned positive in the New Year. This allowed tax-exempt prices to rebound, which can be seen in one of the most watched municipal bond indicators; the municipal to treasury ratio. After hitting a high of 108% (tax-free yields above Treasury bonds), the ratio of 10 year "AAA" rated municipal versus comparable maturity Treasury bonds declined to 94% to end the first quarter.

In terms of fiscal health, this is a stressful time of year for municipal bond issuers as the new fiscal year (2018) for virtually all jurisdictions begins on July 1st. Budget planning, political debate, revenue projections and expenditure pressures are all in play. Just as important, there is little time left this fiscal year to cut expenditures to necessary levels and avoid drawing down on already light reserve levels. In short, this is the season for "potential surprises".

States that are tightening their belts to prepare for a more uncertain political and economic environment are partially reacting to the following facts. Below are a few summaries from the Rockefeller Institute of Government:

- Projected federal revenue streams may be cut with uncertainty over Medicare and other aid programs
- The median income tax forecast for fiscal year 2017 now calls for 3.6% growth, down from the previous median of 4.0%
- The median sales tax forecast for 2017 anticipates 3.1% growth, down from the previous 4.2%

The weak revenue forecast is a function of many key "big picture" themes highlighted in this publication regularly. Namely, "stall speed" economic activity, slowing level of spending habits of Americans, low birth rate, low productivity, high debt and unfunded pension levels.

Despite the following high profile deteriorating credits (such as those discussed often by RSW: State's of IL, NJ, CT, PA), the general health of the municipal market remains strong although uneven. We continue to seek out tax backed issuers that demonstrate good management, strong economies, and fiscal solvency. Revenue bond selection stresses "essential utility services" and strategic major airports.

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