"There's No Place Like Home" (7/14/14)

We begin this quarter's commentary with a warning. The content found in this report could be deemed by some to be sarcastic or cynical. After several failed attempts to change our attitude, we made an executive decision: sarcastic and cynical is how we will sound.

Cheerleaders or Prognosticators?

What got us up on the wrong side of the bed was not the USA's loss to Belgium in the World Cup (although heartbreaking), but the annual "parade" of mea culpa's offered by the Federal Reserve, IMF, and most main street economists. For the last four or five years, these pillars of economic wisdom have consistently overestimated the pace of world growth, and now, predictably, are busily ratcheting down their annual GDP forecasts. The latest miss by the Federal Reserve was registered in the first quarter of 2014 as the pace of growth contracted by 2.90%, versus a forecasted rate of +2.00%.

Simultaneously, the Federal Reserve lowered their projection for the full year 2014 to 2.10%, from 2.80%. Perhaps Janet Yellen needs to be reminded of an old expression that "a closed mouth gathers no feet", because in order for her 2.10% projection to be realized, GDP will have to grow at roughly 4% in each of the next three quarters. This seems rather unlikely, since the last time that the U.S. economy grew at 4% or more over three consecutive quarters was in 1983.

It's hard to imagine why, but there are those who are actually paying close attention to the Fed's 2015 and 2016 growth predictions. Does it only seem obvious to us that if you miss the first quarter 2014 forecast by nearly 5%, that maybe forecasting 2015 and 2016 economic growth is perhaps just a little outside your skillset?

Akin to the Fed, the forecasting track record of the IMF has also been quite poor. What is striking to us though, is not just the size of their misses (yes the Fed's too) but the fact that all of the misses are in the same direction. They have all been too high! It is uncertain what these economic wizards are doing, but we are hard-pressed to call it forecasting.

If they were truly adding up all of the economic pluses and minuses with the goal of projecting GDP, could their prognostications truly be this bad? Unlikely! It is more plausible that overly optimistic information is being "spoon-Fed" to John Q Public in an attempt to boost their level of confidence. Therefore, to us at RSW, we believe the policymakers are busier behaving like cheerleaders waving their "pom poms" than prognosticators.

While we are attempting to add some elements of humor, what is happening globally is actually quite serious. Growth occurs in fits and starts, wage growth is stagnant, deflationary forces are a huge concern in many countries, debt has exploded serviced by a ZIRP (Zero Interest Rate Policy), aging populations are straining government budgets and growth levels, and a low participation rate in the labor force is further evidence that we are in the midst of a long protracted battle to attain an elusive "self-sustaining recovery".

To Be Young Again…

For over five years we remained steadfast in our view that the Central Banks lack the antidote for this "strain of global economic flu". You need to look no further than the structural issues mentioned above, which have all been discussed in prior RSW musings. Another impediment to "normalcy" is unemployment and underemployment amongst our youth, as their predicament is not alleviated by the “financial engineering” initiated by the World's Central Banks.

According to the International Labor Office, the global rate of youth unemployment (aged 15 to 24) totaled 12.7%. However, the scope of the problem tends to vary greatly across countries. Roughly 55% of those under age 25 in Greece and Spain were unemployed compared with the youth in East Asia and South Asia where the rate of unemployment is 9.5% and 9.3% respectively. Here at home, our nation’s young people have been suffering worse than in many locales. A recent study published by Pew Research unveiled a whopping 36% of the populace between ages 18 and 31 are living with their parents. The last time we saw this many young adults living at home was in the 1960’s.

When individuals are “bunking” with their parents, there are numerous economic consequences that are far reaching. For example, youths are struggling to:

- Start their own families
- Purchase homes or rent apartments
- Purchase items such as furniture, carpeting, microwaves and TVs
- Pay taxes

In addition:

- The lower level of demand for goods and services detracts from overall economic growth.
- This, in turn, impacts businesses, causing them to rethink hiring decisions.
- Young people struggling to find permanent jobs are bound to accept temporary and intern positions.
- This leads to lower wages and worsening career opportunities.
- There is a risk of losing talent and skills.
- Overall, this creates a loss of tax revenue and increases the demand for government-provided services such as unemployment, healthcare and welfare payments.

Let us give you what we at RSW believe is a marvelous example of what has come to be called the optimistic and the pessimistic view (or better called “those who believe the problems are cyclical and those who believe they are more structural”). A recent conference discussion focused on the fact that youth unemployment is a serious problem in that fully 1/3 of our youth 18-34 are living with their parents. One of the participants at this conference said that “this means there is a lot of pent-up housing demand". That one quote summarizes the divide perfectly. Optimists believe the employment situation is only temporary and that the youth will eventually create new households. Pessimists believe that old higher paying jobs (with enough income generated to support a household) are permanently lost, and there is little sign of them coming back.

What Does the Bond Market Believe?

Are the worldwide levels of market interest rates a better forecaster of growth and inflation than economists? If Japanese investors really believe that Abenomics will create 3% growth and sustainable 2% inflation, would 10 year JGB's continue to trade at 0.60%? Also, despite Mario Draghi's promise to do "whatever it takes to save the Euro", why are Spanish and Italian interest rates offered at virtually the same yield of U.S. Treasury Bonds? So, if investors really believed in a sustainable 3% growth and 2% inflation rate would traders and investors be purchasing UST 10-year Bonds at 2.53%?

The World Bank, Federal Reserve, and the IMF have said that if it were not for bad weather, events in the Ukraine, inventory drawdowns, and a slowdown in the pace of growth in China, the global economy would be performing much better. Certainly these events served to depress the level of growth in the first quarter, and therefore we would not be surprised if second quarter's growth surprised to the upside. Should this occur, can the "bulls" declare an economic victory and the market respond by pushing market interest rates higher? Certainly over the near term this is possible, but a one quarter "wonder" does not a long-term trend make!

While we will not reiterate our case for the sustainability of a low interest rate environment again, we believe that too many "kids" continuing to live in their parents' basement is a microcosm of the long-term issue that cannot be solved by merely "printing money". While time and events have already proven our long-standing hypothesis, there are two question that remain: How many of the basement dwellers truly believe "There's No Place Like Home" and how many truly have no choice?

Tax-Exempt Commentary

As we discussed in RSW's 2014 Outlook, "We fully anticipate a sharp decline in new issue volume during the course of the year". It was this decline in the volume of new issuance that provided the impetus for the asset class' strong absolute and relative performance during the second quarter.

Yields in the municipal bond market continued their descent during the period. Likewise, tax-exempt bonds continued their recent trend of outperformance vis-á-vis the U.S. Treasury bond market. For example, 10-year "AAA"-rated municipal bond yields declined by 23 basis points versus 18 basis points for like-maturity U.S. Treasury securities. In terms of credit quality, Puerto Rico debt continued to grab the headlines and attention of municipal investors.

Puerto Rico's Deteriorating Credit is Not Indicative of the Strength of the Municipal Market

Structural and fundamental credit weakness was always apparent even when the Commonwealth and its various public authority debt ratings were in the "A" category.

With that in mind, RSW has never invested client funds in any Puerto Rico obligations.

Professional municipal market participants should not be surprised by what some may consider the recent and rapid deterioration in the Commonwealth's various bonding programs for the systemic weakness was always apparent and became "as clear as day" during the past recession and the weak recovery that bypassed Puerto Rico.

Nevertheless, despite ongoing credit concerns for specific issuers, Puerto Rico's problems are not characteristic of the high grade municipal market which comprises the base of RSW's client municipal holdings.

The myriad of concerns, amongst others, includes high debt levels, a weak economy coupled with high unemployment and an oversized governmental labor force, no engine for growth, oversized pension liabilities, a dependency on imported oil with high electricity costs that leave little realistic room for rate increases, and a significant underground economy. Over the past decade these issues contributed to operational and recurring deficits, weak liquidity, negative fund balances, deficit financings and exploding pension liabilities.

The recently enacted **Puerto Rico Public Corporations Debt Enforcement and Recovery Act** is the Commonwealth's drastic (for bondholders) solution to the current morass. The purpose of the Act is to give the various Puerto Rico public authorities the legal ability to "restructure debt". The Act is "necessary" because the Commonwealth, just like the 50 states, is prohibited from filing for bankruptcy under Chapter 9. The premise that supposedly supports the legality of this Act rests with the Commonwealth being unable to perform the basic functions and duties of a government and that therefore this trumps any contract impairment. Two mutual funds have already filed legal challenges.

What Happens Now

- Moody's has downgraded Puerto Rico's general obligation and Cofina bonds to just above default status to B2 and B1 respectively, with negative outlooks, even though under the Act these bonds are not subject to a restructuring.
- The various banks with lines of credit outstanding or expiring have given the Electric Power Authority ("PREPA") an extension until the end of July to pay back short-term loans.
- PREPA has approximately $700 million in short-term obligations due by mid August.
- We fully expect that a "restructuring" of PREPA and Highway debt will be "in the cards" as to "free up funds" to repay short-term debt, fund operations, and capital improvements. This is especially relevant as the recent downgrades by Moody's do little to support or encourage market access for any Puerto Rico debt.

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