Take Your Transparency, Your Forward Guidance, and Taper it!

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"To think output and income can be raised by increasing the quantity of money is rather like trying to get fat by buying a larger belt."-- John Maynard Keynes

In the fourth quarter of 2008, RSW abandoned a longstanding tradition to include a section in each Quarterly Commentary entitled "Fed Watch". Our reasoning was that with the Federal Reserve's overnight target interest rate close to zero, their relevance was greatly diminished. Since that time, the Federal Reserve attempted to stimulate the economy by allowing our representatives in Washington to run-up large current account deficits. In essence, the Federal Reserve became the "enabler" -- loaning money to the Treasury department ("QE") via purchasing large swaths of the Treasury's new bond issuance.

In order for the Fed to continue to better control rates after QE is completed, they have offered transparency in the form of "forward guidance". This practice provides the financial markets a time frame of how long the Federal Funds rate will stay anchored at zero percent, and attempts to smooth volatility so that market participants are not caught "off-sides" when a policy shift occurs. What can possibly be wrong with Ben Bernanke offering greater transparency so that it's easier to predict what the Central Bank will do, and when?

Breaking Bad

Flaws have recently been exposed that serve to highlight why the experiment of transparency is "Breaking Bad". To begin, when there is too much certainty about interest rate policies, market participants tend to get on the same "side of the boat", leaving fewer investors or traders to take the other side of the buy or sale transaction. While transparency can cause levels of price volatility to be muted over short periods of time, a spike in volatility is almost always inevitable. This unavoidable consequence reared its head in May, when the Fed began releasing details of the economic events that would be necessary to justify a "tapering" of their monthly Treasury bond purchases. As a result, volatility spiked, liquidity sank, and so too did most financial markets.

Transparency suffered another credibility hit in May as the details of the current guidance communicated by the Federal Reserve proved to be erroneous. Maybe this is another reason why Alan Greenspan (former Federal Reserve Chairman) shuddered at the thought of transparency. His belief was: "I know you think you understand what you thought I said, but I am not sure you realize that what you heard is not what I meant." Initially, Bernanke made it clear that the unemployment rate would need to fall to 7 % before tapering would be triggered. Then, at Bernanke's latest address in September,he reversed his position on this "guidepost" by stating that the unemployment rate "is not necessarily a great measure" of the overall job market, and in fact may be a misleading indicator.

In essence, Bernanke is communicating what we at RSW have alerted our clients to for some time. The increasing level of part time employment, the flat level of wage growth, and the low participation rate (shrinking labor force) are distorting the value of current employment measurements.

You Can't Possibly Make This Up!

In September, the Federal Reserve decided unexpectedly not to "taper" the pace of its $85 billion ($45 billion Treasury + $40 billion mortgage-backed) of monthly bond purchases. One of the reasons cited was the "tightening of financial conditions". That's right, the spike in interest rates caused by Bernanke's tapering communiqué in May, is now being cited as a reason not to taper in September. Sounds like a negative feedback loop to us. You talk taper, rates rise, the economy slows, then no taper. Perhaps the investment community's respect and belief of forward guidance should be added to the list of things that need to be tapered.

While the markets were busy recalibrating the pricing of securities to prepare for a tightening of monetary policy, the Federal Reserve just eased yet again. Yes, easing! We say that because, going forward, the Federal Reserve, continuing at its current pace, will be purchasing a larger share of all new Treasury bonds issued during the upcoming year. Think about it. When the annual federal budget deficit was hovering around $1 trillion, the Federal Reserve was purchasing approximately $540 billion of U.S. Treasury bonds ($45 billion each month), or roughly 54% of the $1 trillion of all new annual Treasury bond new issuance. Now that the annual budget deficit is projected to shrink to $750 billion annually, and the pace of bond buying is unchanged at $540 billion, the Federal Reserve's bond purchases should total approximately 77% of the annual new issuance.

Self-breaking mechanism

The recent economic releases do not appear to suggest that the Federal Reserve's milestones are closer to being fulfilled than they were at the beginning of the year. So while the Fed is prepping us for a change of policy, the markets are twisting, trembling, tossing, and yes "twerking", while through it all, the economic data remains stagnant. Many pundits are attributing the flat slope of U.S. growth to a "transmission mechanism" that is blocked or broken between financial markets and the real economy. Well this is not the difficulty. The problem is that there isn't enough demand from the "real" economy to receive the transmission being generously sent from the financial markets. How can there be growing economic demand when the level of household income just doesn't support the spending necessary to provide the upward "umph" (technical term) to economic activity? By now, it should be crystal clear that the Fed can only buy bonds until there aren't any more left to buy. However, it's not going to miraculously change a $10 per hour bartender's job into a $75,000 a year management job.

For much of this year, the rhetoric heard on most current financial shows seems to us to be more disconnected from reality than ever before. Remember way back a month ago when the emerging strength of the economy was all the rage. It would appear that some market pundits sold themselves on the idea that, in spite of rates soaring 100 basis points (taking mortgage rates higher), and the Fed even mentioning a taper, miraculously we will usher in a growth spurt in the U.S. economy. We are in the middle of a familiar sequel; Q2 GDP came in at 2.50%, and the estimate for Q3 GDP has been lowered to 1.80%.

In the past, we talked of a "dangerous world" (RSW Q4 2011 Commentary entitled "Games People Play"), and in general commented on the vast number of "fractures" in the global economy and financial system. Now we are talking about something that has already happened here, or at least is in the process of happening: Rising Rates! It's like two trains running away from each other. The pace of economic activity in the United States seems to be decelerating, while at the same time market yields are climbing.

On many occasions, we have written about the self-breaking mechanisms that we believe are in place to keep a lid on just how high market yields can rise. Given the fragility of the economic recovery, it remains our view that a sustained period of higher interest rates will serve as a meaningful impediment to a more normalized growth rate. Whether the market raises rates, or the Federal Reserve leads the rise, economic activity does not know the difference. Rising rates hurt either way. Put another way, the Federal Reserve has been keeping interest rates at historic lows for years because they are "afraid" of something. Perhaps, they understand that because of a climbing debt burden, interest rates must remain low. The Federal government and the broader economy simply can't afford higher interest rates. Therefore, it should become a self-fulfilling prophecy that today's higher levels of rates should ultimately undermine the rate of growth, thereby serving to usher in another period of low interest rates.

The points mentioned above potentially carry significant implications for risk assets as well. As you may recall in RSW's Q1 Quarterly Commentary entitled: "Is Now the Time to Exit the Cave", we introduced the concept that a zero bound interest rate market can create the illusion in which asset classes are "cheap". Specifically, we said: "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". Remember, one of the goals of QE is to inflate all risk assets, and as this occurs how do we recognize the bubble?

Let's use gold as an example. Remember back when gold was valued at $500 per ounce? Some pundits categorized the metal as "fundamentally cheap"…good call! Gold rose fairly steadily above $750 as its appeal broadened. Then the housing bubble burst and gold ripped through $1,000 an ounce, as pundits feared the collapse of the financial system. To save the financial system, QE was created and this policy drove down the value of the dollar, so gold was touted yet again as the only "currency" that couldn't be debased and its price climbed to $1,500. Growth stagnated, money printing accelerated around the world, the dollar declined again, and the chorus grew that gold was the place to be. Talk of $2,000 an ounce was everywhere, as its price peaked at $1,920.

All of the dynamics used as reasons to own gold accelerated -- and yet today gold sells for $1,300 an ounce. The question that money managers and asset allocators need to continuously ask in today's financial system is: when does an asset's price exceed a level that that even oceans of liquidity can't sustain? Now that interest rates (the bench-mark for which assets are valued) have climbed by approximately 63% (10 year US Treasury bond yields rising from 1.60% to 2.60% as of this writing), are other risk assets also supposed to be re-priced? During this latest surge in bond yields, some individuals were fleeing to asset classes in which prices were rising. Most investors think of risk only in terms of an entities ability to prosper and pay its investors. Risk also comes in the form of paying too high a price for an asset. Apple is only one example. We realize these are questions, and not the answers that some are looking for, but the answers must be pondered. The trend we pointed out earlier in the year still rings true: "Many are deploying an 'overweight' amount of monies in sectors they would previously have deemed to be unsafe, even before the financial crisis began."

At RSW, we remain convinced that the Federal Reserve's policy of QE, coupled with the latest strategy of confirm and confuse, shouldn't serve to stimulate sustainable "historical trend" levels of economic activity. Perhaps an article published by John Maynard Keynes summed it up best in a letter to President Roosevelt in 1933. He stated: "To think output and income can be raised by increasing the quantity of money is rather like trying to get fat by buying a larger belt."

Push Comes To Shove:
The Strong Get Stronger and the Weak Get Weaker

For the third quarter, the total rate of return of the broad municipal bond market index was down 19 basis points (-0.19%). One number certainly doesn't begin to tell the story for the period, as the relatively flat performance implies a lack of tumult and volatility. As most of us already know, this couldn't be further from the truth. Tax-exempt yields spent the first two months of Q3 climbing sharply, only to fully reverse this increase during the month of September.

While municipal bond yields are off their highs, they are still offered at levels approximately 84 basis points higher (using 10-year "AAA" rated tax free bonds as a proxy) than where they began the year. Aside from rising Treasury bond yields, the municipal market experienced further pressure as municipal bond fund redemptions spiked from April through mid-September. In fact, outflows totaled just over $40 billion – an amount that rivals the "Meredith Whitney" induced panic of December 2010. During this episode, long-term rates rose more sharply than short and intermediate-term maturities, as mutual funds tend to own bonds maturing beyond 20 years. Additionally, some would argue, fears attributed to Detroit's bankruptcy filing, and Puerto Rico's ongoing fiscal and economic morass, contributed to market weakness.

At RSW, we believe…

- The increase in yield levels has made high quality investment grade municipal bonds more attractive, especially as broad economic activity continues to stagnate or weaken.
- Conversely, lower-rated bonds and "high yield" municipal bonds should continue to underperform and be subjected to credit deterioration in such an environment.
- There is a strong possibility that at least two of the three major credit rating agencies over the next 6 months could downgrade practically all Puerto Rico debt to below investment grade. "Junk status" could lead to further "induced selling" by mutual fund managers to meet another potential wave of fund redemptions. Weak liquidity for such bonds could add to further price deterioration amongst all high yield muni credits and sectors.
- Detroit's bankruptcy filing was a long time in the making and no real surprise.
- Detroit's bankruptcy filing seeks to treat the city's unlimited full faith and taxing power general obligation debt as unsecured debt and therefore subject to default with minimal, if any, pay out. This has upset many "apple carts" including municipal bond insurers, the rating agencies, and institutional and retail investors.

- In fact, on October 1st, Detroit did not make the scheduled debt service payment due on its general obligation bonds.

- There is nothing inherently sacrosanct about an unlimited general obligation pledge. After all, what is the definition of a credit rating? It is nothing more than a measurement of the degree of proximity to default. Yes, the market makes credit and pricing distinctions, and rightly so. "AAA"-rated general obligation bonds are obviously a better credit than a "BBB"-general obligation bond. If not so, than why wouldn't investors purchase "BBB"-rated general obligation bonds at higher yields if there was no possibility of losing money?

- Ultimately, the court will opine on the fairness of Detroit's bankruptcy plan.

- Municipal defaults and bankruptcies will continue to be rare and isolated events. According to Moody's, there have been only 16 local government defaults since 1970 in a universe of approximately 12,000 local government credits.

- Additionally, since 2008, bankruptcy filings by eligible general purpose local governments account for a minuscule 0.06% of that universe. Successful filings (excluding those rejected) account for a paltry 0.02%.

- Despite the headlines generated by Detroit and Puerto Rico, they remain outliers, and are not and will not be symbolic of the larger overall municipal market.

At RSW, our credit research is forward looking and seeks to avoid tomorrow's problems and challenges today. This explains why we have never loaned money to the Commonwealth of Puerto Rico, and for years have avoided the State of Illinois and most of its related issuers. At times, this could certainly limit the yield that our investors can earn, but from our perspective, principal preservation is tantamount and a cornerstone of our decision-making process.

Robert S. Waas Managing Member	Robert S. Coates Senior Portfolio Manager	Matthew T. Werner Portfolio Manager	Mark J. Tenenhaus Director of Municipal Research	John A. Carlson Director of Business Development	Marites V. Pasturan Data Analyst	Randy J. Fox Operations Associate	Brian E. Pawl Operations Associate	Irina R. Brooklier Client Service Associate