## Pin the QE on the Donkey (10/14/14)

- *Given our view that economic growth will fall below the average consensus of economists, we do not believe that a rate hike is automatic.*
- *If the Fed does hike rates, how will bond holders be affected? To answer this question, it is important to understand the reason why the Fed would consider raising short-term rates.*
- *The low interest rate call that we have maintained for years is an outgrowth of the question that all guardians of clients' assets should ask: How can interest rates normalize (10 year US Treasury rates hold above 3.50%), when massive levels of liquidity injections and asset purchases have failed to induce growth or inflation?*
- *With worldwide growth weak, and/ or weakening, it is hard to see how everyone escapes from the disinflation in which the world resides.*
- *While many feared that all of the excess dollars sloshing around in the system would generate runaway inflation, the remarkably low global yields tell a different story.*

### Fed Fever

Market participants continue to hang on Janet Yellen's every word for clues about the timing of a future interest rate increase. While instructive, we believe it is more important to analyze the investment implications of such a policy shift. So what you can expect to glean from this report is our assessment of the global economy, interest rate markets, and our conclusions about how an interest rate hike may impact our client portfolios. Given our view that economic growth will fall below the average consensus of economists, we do not believe that a rate hike is automatic.

Pundits continue to point to the Federal Reserve's "tapering" of the Quantitative Easing (QE) strategy as a signal that a rate hike cycle will soon commence. While this is a possibility, it could also be that the Federal Reserve is concluding their asset purchase program (Treasury and Mortgage bonds) because they realize the declining marginal benefit may begin to outweigh the program's risks. Furthermore, concerns continue to mount that the liquidity provided by the QEs has inflated the price of risk assets to levels that some Central Bankers say are "frothy".

There is no denying that each new stimulus action (QE1, 2, and 3) seemed to buy less and less GDP growth. This is not surprising to us at RSW, since we never believed that an antidote for this strain of economic flu exists in the laboratory of Central Bankers. In 2013, Jeremy Grantham (GMO LLC) said the following about Fed Chairman Bernanke: *"The Fed is beating a donkey (the 1% growing economy) for not being a horse (his 3% growing economy). I assume he keeps beating it until it either turns into a horse or drops dead from too much beating! "* - Perhaps Yellen knows that she is riding a donkey (weak growth) and is putting the riding crop (QE) back into the holster because it is both ineffective and carries unintended consequences.

We must also be mindful that the world is littered with donkeys ("jack-asses") that we all wish were thoroughbreds. Just look around the globe. Has a persistent easing of monetary policy and QE activity lifted countries out of their economic morass?

"Sloppy" Conditions:

- Chronic high unemployment that is highest amongst the young.
- Stagnant median income growth is fueling a wider chasm between the "haves" and the "have nots."
- Exploding pension and medical benefits far beyond growth rates.
- Rampant levels of Government debt.
- In the United States, massive levels of student loan debt.
- Demographic changes that make home ownership generationally less affordable.
- Out of control medical and educational costs.

While many pundits "Ooohhh" and "Aaahhh" over the stronger pace of second quarter 2014 GDP (+4.6%) and draw a conclusion that the good times are back, it is important to note the following: Over the past three years, GDP has only exceeded 4.20% twice. Each time this has occurred, below trend (3%) economic growth followed. The reason is that periods of weak demand create future pent-up demand and higher levels of growth. However, it is that subsequent strong growth that borrows from the future, creating offsetting weakness or slow growth and consumption.

What's Going on Around the Globe

With worldwide growth weak, and/or weakening it is hard to see how everyone escapes from the disinflation in which the world resides. As the world's largest Central Banks declare deflation to be public enemy #1, their goal is to get the rate of inflation to at least 2%. While success has been spotty at best, what policy makers seem oblivious to is that wages (keystone) for too many have barely budged.

Think about the dynamics behind "Abenomics" (Japanese prime minister Shinzo Abe's approach to stimulating Japan's growth and inflation) in Japan. They have lifted inflation to a temporary 3.40% but even when the distortions of the sales tax increase (raised to 8% from 5% in April) are removed, inflation only stands at 1.30%. Inflation is sought after to lessen the effects of Japan's high interest expense burden. The problem remains that wages haven't been elevated, and even more importantly about 30% of the populace are retired and living on pensions. So pursuing a higher inflation objective ultimately punishes consumers and spending, and hence, the pace of growth. For this reason it is the higher level of inflation that prolongs deflation, if not exacerbates it. We at RSW have long espoused the view that goods and services inflation (necessities), without the concomitant wage inflation, is actually deflation in waiting.

In the Eurozone, deflation is considered the most urgent because unlike Japan it is a new concept for them. Their annual inflation rate stands at 0.40% against a historical average between 3 and 4%. The world shares many things in common but significant factors are different. The Euro-zone shares Japan's demographic issue of a large retired population, and unlike the U.S. their unemployment rate has remained stubbornly high, presently 11.40%. Combine retirees and the unemployed and you can see where inflation would be lethal, and yet their unstoppable high levels of interest expense due to bloated debt levels make inflation mandatory.

We have often said that economics are inherently complex and defy easy clean analysis. Whether the world suffers from too much debt, depressed wages, or reduced total demand or "secular stagnation", one thing cannot be denied: global growth remains muted by historical standards and therefore exceptionally vulnerable to shock, sudden or otherwise. This has created an almost universal need for Central Banks to force rates lower to service debt and to try to foster higher final demand to create growth and investment.

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Potential Impact of a Rate Hike

How will bond holders be affected? To answer this question, it is important to understand the reason why the Fed may hike short-term rates. Specifically:

If you believe that sustainable growth (3%+) and inflation (2%+) are returning to levels that are close to their historical trend lines, then you believe that rates will have a meaningful and permanent shift higher.

- This may be similar to the January 1993 to February 1995 period where the Fed hiked rates by 300 basis points, and the Barclays Capital Municipal Bond Index (Market Duration Strategy Benchmark) declined by (-3.56%). This occurred as the yields on long maturity municipal bonds rose in sympathy with the rise in Federal Reserve "controlled" short-term interest rates.

We at RSW, however, have been in the camp that believes there are structural issues that are keeping growth and inflation below trend, and rates lower and for longer than most expect. Therefore, we believe that if the Federal Reserve hikes rates, it will be for reasons that are not related to traditional economic fundamentals (growth, inflation etc). For example, the Fed may elect to raise rates to pursue a strong dollar policy, lift the interest income for savers, or deflate the price of risk assets. In fairness, we cannot recall a time when the Fed has ever shown an inclination to pursue that course. In any event, we believe that given today's fragile current economic conditions, Fed activity could cause dramatic dislocations.

As we stated in RSW's Q1 2006 commentary: "We believe that they will 'overshoot' on the degree of their tightening campaign. Looking back on the Fed's long-term track record, we have endured eight Fed tightening cycles in the past three decades. The Fed has inverted the yield curve (short term interest rates were higher than longer maturity bonds) on five of those occasions, and out of those five rate-hike induced inversions, the economy has skidded into a recession one year later all five times."

The sixth tightening cycle ended in 2006, and it is indelibly etched in our minds. Will the Fed risk number seven? So what could investors expect under these circumstances?

- *While past performance is no indication of future returns,* during the 2004-2006 rate hike cycle, the Barclays Capital Municipal Bond Index produced a gross average annual total rate of return of 4.28%. This occurred as long maturity municipal bond yields actually declined despite an aggressive 425 basis points of rate hikes. Remember, the Fed can only control short term interest rates. If market participants believe that the Federal Reserve is "over-tightening", and risk causing an already slowing economy to slip into a recession, investors and traders will buy long-term bonds.

As you can imagine, our "game plan" is already pre-determined. We would view any meaningful rise in longer-maturity (determined by market forces, not the Fed) rates as temporary (10 -year Treasury bond yields around 2.75 – 3.00%), and as such, an opportunity to reposition client portfolios by lengthening average maturity, average duration, etc. to enhance the portfolios' yield.

**Are There Thoroughbreds or Donkeys in This Race to Zero?**

Lastly, the world's central banks have tripled the amount of "excess reserves" in the financial system since the financial crisis commenced. While many feared that all of the excess dollars sloshing around in the system would generate runaway inflation, the remarkably low global yields shown below tell a different story. ***Despite unprecedented central bank stimulus to offset "structural" headwinds, we believe that global growth should continue to disappoint to the down side. Further, as we've said in the past, it is likely that the Fed should remain impotent in fighting this particular strain of "economic flu".***

10-year maturity yields (as of 10/14/14)

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| United States | 2.21% |
| Canada | 1.94% |
| United Kingdom | 2.13% |
| France | 1.20% |
| Germany | 0.84% |
| Italy | 2.30% |
| Spain | 2.04% |
| Portugal | 3.05% |
| Switzerland | 0.40% |
| Japan | 0.49% |

**Municipal Watch: Going on 5 Years of Tepid Recovery**

At the close of the third quarter, preliminary new issue volume for the year-to-date was an approximate $27 billion, or 11% less than the same period last year. For many important issuers of municipal bonds, the year-over-year decline was much more pronounced. Through August 2014, the year-over-year decline for California and Florida was roughly 25%; for New Jersey the decline was almost 40%. New issue volume for New York and Texas was essentially flat. Importantly, roughly 50% of the new issue supply constituted refunding of outstanding bonds and therefore added nothing to the available supply.

This lack of supply helped performance on the longer end of the curve as yields declined by approximately 20 basis points to a 2.86% level as measured by MMD's "AAA" general obligation 20-year curve. Price levels on the short end of the curve (5 years), were relatively unchanged during this period, while the 10 year level appreciated by almost half of the longer end of the curve.

Preliminary data from the Rockefeller Institute shows that state tax collections during the second quarter of 2014 actually declined by almost 2% from the same period last year with fully 29 states recording declines. To some degree, the declines can be attributed to shifts in personal income tax collections from tax year 2013 to 2012. We will wait to see if income tax collections improve during the course of 2014 and 2015. Nevertheless, this was the second consecutive quarter of year-over-year declines as first quarter 2014 revenues were 0.3% less than the same period last year. The last time consecutive quarterly declines happened was the fourth quarter of 2009.

What may be more revealing is the following: The Institute goes on to state that while state sales tax collections were virtually 10% higher during the first quarter of 2014 compared to the same period back in 2008, when adjusted for inflation, sales tax receipts have increased by only 0.6%. While most state budgeting has been conservative over the past five years, there remains strong and growing pressures to increase spending from various interests and constituency groups as state budget cuts through the course of the recession were somewhere in the neighborhood of $700 billion.

The buildup in this political pressure to restore services and funding (in other words ramp up spending) is not in the aggregate generating headlines. To add to this perspective, as of May 2014, Fitch Ratings reports that only 17 states have reached or exceeded their pre-recession employment peaks. Obviously employment levels have a strong correlation to economic growth, tax collections and fiscal health.

The majority of high-grade municipal credits have stabilized and adjusted well during the course of this tepid recovery- however not all. The duress of Puerto Rico, Illinois, and Detroit have been well publicized (RSW clients have never seen these bonds in their portfolios). New Jersey and Pennsylvania have been subject to various downgrades over the course of the summer of 2014 as pension liabilities increase and structural budget balancing becomes problematic.

***To wit, while RSW's holdings may include New Jersey and Pennsylvania obligations, our strategy is to minimize price volatility by targeting bonds with relatively short final maturities or call dates.***

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