December 16, 2015

RSW's 2016 Investment Outlook

The Rosetta Stone

Municipal Bond Market:
Resiliency Should Not Be Confused with Tranquility

The Rosetta Stone (12/16/15)

Looking Back to Look Ahead

Happy Holidays! With 2015 nearly in the books, it is the season for us to reflect back and score our forecasts versus this year's events.

The Year in Review

In RSW's December 2015 outlook, we offered a perspective that ran counter to the popular view at that time.

What we got right

- Conditions outlined since 2006 support a continued low yield environment...any meaningful rate advance would be unsustainable and prove to be a gift.
- Disinflation/deflation will worsen as the U.S. "imports" deflation from overseas.
- Shrinking new issue municipal volume will continue on a trend line of being below average, thus supporting bond prices.

What we got wrong

- "We are downgrading our GDP forecast from the 2% best case that we have maintained for the last several years, the new ceiling for growth in 2015 should be 1.7%". Although economic activity should shrink this year from the 2.40% pace recorded last year, GDP is now anticipated to eke out a rate that is barely above 2%.
- Although not discussed in RSW's 2015 Outlook, as many of you know, RSW's position has been that the Federal Reserve will not hike rates in 2015.

The Rosetta Stone

A stone dated March 27, 196 B.C. was discovered by a French soldier during Napolean's Egyptian campaign near the town of Rosetta in Egypt. The tablet, which became known as the Rosetta Stone, was inscribed by a group of priests to honor the Egyptian pharaoh. The writings, displayed in three written scripts, including hieroglyphics, provided a key to deciphering this long lost language and to understanding the culture of ancient Egypt. The Rosetta Stone was so instrumental in unlocking language that, fast forward to today, a learning company was formed to teach any language in just 6 minutes flat (RSW's exaggeration).

You must be asking why we have taken you through this archeological dig of linguistic history. We spent the time to provide background in order to inform you of an equally historic document to the financial community, known as the "Alan Ben Yellen scrolls". The historic record dates back to the reign of Alan Greenspan, and was created for the sole purpose of translating pronouncements by the Federal Reserve Chair. Simply put, it takes "Fed-Speak" and translates it in to plain English.

While many of our competitors hire economists, linguistic experts, astrologists, and fortune tellers to decipher the code, we have the scrolls. These scrolls were born in the time of Alan Greenspan when he uttered the following: "I know you think you understand what you thought I said, but I'm not sure you realize that what you thought you

heard is not what I meant". Unfortunately, the scribe originally tasked with translating this, upon reading it, suffered a seizure and had to be replaced. The next man up succeeded and produced the first entry. The scroll says: henceforth we shall speak in tongues until we are sure that the listener is thoroughly dazed and confused.

The scrolls were later handed off to Ben Bernanke who faithfully agreed to maintain them. Noting that the economic environment looked "dicey", together they decided that the main goal should be to *instill confidence* in the markets, and the public at large. After the housing bubble burst, he had his chance to put that into practice. In May 2007 he said: "we believe that the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillover from the subprime market to the rest of the economy, or to the financial system." However, the scrolls read quite differently. The translation was: Yikes! This thing feels like the “Tower of Babble”, and I hope my nose doesn't grow during a live interview on CNBC.

After two terms Mr. Bernanke, tired of living in crisis mode and losing his knack for being bilingual, passed the scrolls to Janet Yellen. Our first woman Chair has not encountered similar economic upheaval, but is charged with reversing the extraordinary monetary policy of Mr. Bernanke. While she is still quite new to the job there are certain impressions that we have begun to form.

She seems to be from the “Two Handed School” of Economics that says: on the one hand…and on the other hand…" She speaks of moderate growth but mentions "structural drags". It is fair to say that her leadership is so new that there are few scroll entries that caught our eye. But the next one did based on the following two Janet Yellen quotes: "Risks to the outlook for economic activity and labor markets appear nearly balanced"; "If the outlook worsened the Fed might weigh negative rates." The scrolls summarized this concisely: Eeny, meeny, miney, moe.

Unlike our fantasy scrolls, the Fed has been attempting to deliver the markets a message. To uncover the message one needs to look no further than the minutes of the last Federal Reserve meeting (10/28/15). These need no translation, and they could be considered the **Rosetta Stone** for future rate expectations. In its distilled form, it discussed the probability that the neutral, natural or the equilibrium rate (the funds rate that is neither restrictive nor stimulative) may be *structurally* changing. Some of the highlights of the report are as follows:

- The neutral rate is currently at zero
- The rate is expected to rise "but probably gradually"
- In the short to intermediate term, the rate would likely remain below the rate of previous business cycle expansions.
- In the long run, the funds rate (in the absence of future economic shocks) would likely be lower than in previous decades.
- Rates are expected to remain low if productivity does not pick up and if demographic projections for slow growth in working-age populations are borne out.
- A smaller gap between the equilibrium rate and zero, might increase the frequency of episodes in which policymakers would not be able to reduce the federal funds rate enough to promote a strong economic recovery.

Their bluntness is the polar opposite of "Fed Speak". Think about what they are saying! Notwithstanding a recession, the Fed expects rates to rise much more gradually and top out short of historical levels. Furthermore, it is interesting that they chose to include the two main causes of structurally lower economic activity and interest rates. Namely, a slowing population growth, and low productivity. We were not only struck by their clarity, but in addition, Ms. Yellen chose to discuss the topic again at her Congressional testimony and then again at a speech to a Washington D.C. business group.

We cannot know why the Fed is beating the drum for structurally lower rates going forward. Whether she is trying to calm the markets about a rate spike or for some other reason is really not important. What does matter is that the financial markets spend 90% of their time and energies stressing and guessing about the date and time of a "rate liftoff" by the Fed, and 10% on what happens beyond that. As investors, it seems to us that it should be the other way around.

After exiting his Federal Reserve post, Ben Bernanke added further clarity as he addressed a group of investors in a New York restaurant. He was quoted as saying that he does not expect the federal funds rate to rise back to its long term average of around 4% "in his lifetime". Think about the implications for the financial markets. The next time you hear a Fed Chairman or Board Member say that they want to "normalize" rates it may have a very different connotation than it has historically.

We at RSW are *not* saying that rates can't rise. We all should admit that rates are somewhat artificially low due to the gravitational pull of European and Japanese rates. But neither should we be using history to measure how abnormal they are.

Oh, there is one more thing. Illustrative of the low level of discourse as it pertains to rate increases, Congressman Brad Sherman of California recently discussed the likelihood of a December rate hike. He said" God's plan is that things rise in the spring so, if you want to be good with the Almighty, you may want to delay until May". If the scrolls did exist and we were able to decipher them, we are fairly certain they would say: "God help us all".

Looking Ahead

- While our projection for longer-term (12+ months) economic activity calls for continued weakness (below 1.50%), there remains a possibility that it won't occur on a straight line. As always, we would not be surprised by a GDP growth rate that exceeds 2.5% for any particular quarter.

Cracks in the global economy appear to be worsening. While U.S. economic activity held up a bit better than we expected, deflationary forces are taking their toll, and should continue to provide headwinds to our nation's growth rate. While many were hailing the decline in energy costs as a net positive for consumer spending, we firmly stood on the opposing side of that debate. We believed job losses in the relatively high paying energy sector, coupled with a shrinking level of capital expenditures should counter the extra pocket cash that could be spent by consumers.

- Using the 10 year U.S. Treasury bond as a proxy, yields should continue to be relatively well behaved, as 2.75% should cap any upward movements. Should the Federal Reserve hike rates in a manner that is inconsistent with weakening economic activity, longer-maturity bond yields can fall precipitously.
- The rate of inflation as measured by the Core PCE (Personal Consumption Expenditures Index) excluding food and energy should fall below 1%, one-half of the Federal Reserve's targeted 2% rate.

Artificially low interest rates and ongoing monetary interventions have been a key driver of both market returns and corporate profitability. However, what has been lacking is sustainable, organic, economic growth. Against this background, the consequence of a hike in overnight lending rates (Fed funds rate) will likely have far more significant impact on corporate profitability, economic growth and market returns than currently believed.

It is significant that each time the Fed has lowered the overnight lending rate, the next set of increases have never exceeded the previous peak. This is due to the fact, that over the last 35 years, economic growth has been on a continued decline.

Municipal Bond Market: Resiliency Should not be Confused With Tranquility

“But on the 7th year you shall let the land rest and lie fallow”- (Exodus 23:11). It is now fully seven plus years since the start of the Great Recession and while the land is not exactly fallow it is not exactly blooming either. This is the slowest post recession recovery on record by far. Case in point, employment levels today are barely over 2% above the prior pre-recession peak. Compare this to the same points in time post the 1973, 1980 and 1990 recessions when employment levels were 12% to 17% higher than the previous peaks. In fact, 15 states, to date, still have employment levels that lag pre-Great Recession levels.

It is therefore not surprising that the growth in state and municipal tax revenues has been relatively slow and sluggish. What may be a surprise is that we fully expect that 2016 will see a further slowdown, not an increase, in growth of tax receipts. This is already in evidence in the waning months of 2015. What is also in evidence is the month-to month declines in new municipal bond issuance. It would therefore also not be a surprise if municipal bond issuance actually declines next year and that the net supply of bonds reflecting redemptions and maturities also is diminished.

To wit, minimal tax and revenue growth will be a negative credit factor for many states and jurisdictions. Less bond issuance and availability can and may contribute to relative over performance of the municipal sector. With this backdrop, 2016 will be a year for separating the wheat from the chaff.

The Scenario for a 2016 Volume Decline

- November 2015 new issue volume of just under $20 billion was the lowest November volume since 2000. The decline is the third consecutive monthly decline largely attributable to the exhaustion of refunding opportunities.
- Through November, new issuance of municipal bonds due to refunding activity accounted for approximately 60% of the $373 billion of municipals issued.

- It is therefore unreasonable to suggest that this level of refunding volume will continue in 2016 given the precipitous decline over the past few months. To the extent interest rates inch higher from present ranges, the spigot will grow tighter.
- New money municipal volume for infrastructure through the first 11 months of 2015 of only $138 billion is only a paltry 4% higher than the same period last year.
- Despite the significant infrastructure needs nationwide, the static new money bond issuance also reflects the relative weakness of supporting revenues in many jurisdictions and the reluctance to raise fees and taxes in an underperforming economic environment. The forecast for 2016 suggests that this trend will continue.

Tax Revenues Were Mostly Positive in 2015 but the 2016 Forecast is not as Rosy

- State governments rely on sales and personal income taxes and to a lesser degree corporate income taxes.
- Total state tax revenues grew by 6.8% in the second quarter of 2015 from the same period in the previous year. The majority of this growth was directly attributed to personal income taxes reflecting payments and gains derived from the strong stock market of 2014.
- 2016 income tax collections will not be nearly as strong as the prior year given the spotty performance of the equity markets this year. Keep in mind that personal income taxes are the largest component of tax receipts in just over 60% of the states.
- State sales tax collections for the second quarter of 2015 grew by just over 3% from the same period last year- a growth rate significantly lower than the previous 4 quarters.

What to Look for in 2016- Stronger Credits Should Prevail, Weaker Credits Will be Under More Duress

The forecast points to slower revenue growth and less bonds being sold. Nevertheless most state governments and essential service providers will be budgeting for lower growth and therefore should maintain their relatively strong credit profiles. Those jurisdictions that continue to raise taxes in an underperforming economy (Connecticut) and/or confront massive pension problems (Illinois and New Jersey) will see their structural imbalances deepen. RSW continues to emphasize strong credit quality in what remains a relatively milquetoast recovery seven plus years after the Great Recession.

Have a Healthy, Happy, and Safe New Year.

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