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RSW's 2017 Investment Outlook

Investment Outlook: Heads I Win, Tails You Lose

Municipal Bond Commentary: Rates and Ratios Matter

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Heads I Win, Tails You Lose (12/14/16)

Happy Holidays! With 2016 nearly in the books, it's time for us to review and score our forecasts prepared one year ago.

2016 Forecast:

Interest Rates: Ten-year maturity (market barometer) US Treasury Notes (yielding 2.27% on 12/31/15), should not exceed 2.75%... bond yields had room to fall precipitously.

> *CORRECT (although we certainly didn't anticipate the July spike low to 1.35% or the sudden and dramatic rise from there to 2.50%).*

GDP: Economic activity calls for continued weakness…below 1.50%.

> CLOSE TO THE PIN! *Year-over-Year GDP is anticipated come in at 1.80%*

Inflation: The rate of inflation as measured by the Core PCE (Personal Consumption Expenditures Index) excluding food and energy should fall below 1%.

> *INCORRECT: Year-over-Year 1.70%*

Possibly the most unexpected outcome of the US presidential election, besides the winner, is the speed with which the marketplace has transformed the President -elect from an economic wrecking ball to the architect of a "new paradigm". With that has come a surprising one-way bet that growth, higher inflation, and some restoration, or at least a retention of higher paying manufacturing jobs, are all but assured. While those with an opposing, or more tempered outlook are not quite extinct, they are an endangered species and certainly silent.

For the last twelve years we have offered our interest rate forecast and economic prognostications without hesitation and with a track record we are proud of. Today however, while armed with our "base case" forecast, we need to temper our confidence level, and exhibit more flexibility. Political risk has reared its head, and it is the hardest to handicap.

We can summarize our views this way. We are neither believers nor unbelievers in the way that "Trumpflation" has impacted the financial markets. However, we certainly question the wisdom of market participants who are making such a large down payment on the passage of policies (not fully known), their implementation and eventual success. Our core belief remains unchanged. Namely, structural headwinds should keep rates and growth lower than their historic averages. Our purpose here is to communicate those feelings, the probabilities and/or the possibilities of where we are going, and how the investment positioning may change.

Today, the sentiment of the financial markets reflects an outsized bet on "heads" and an underweight on "tails". Gone are the possibilities of a trade war and import tariffs. These fears have been replaced by promised tax cuts, deregulation, cash repatriation, and fiscal stimulus in the form of infrastructure spending. Collectively, these policies, it is hoped, will rekindle the animal spirits, growth, and slay the deflation dragon. While this is certainly a possibility, missing from recent euphoria is what the programs look like after inevitable compromise, how long they will take to be enacted, and do they have the impact that financial markets have already paid for.

Please don't confuse us with trying to throw cold water on the "reflation" possibility because this is not where we are. It's just that bond yields are responding to the near certainty of robust economic activity and inflation partly because of massive infrastructure spending. This is in spite of the fact that we haven't the slightest idea of the final size of the plan and whether any programs will be government financed, privately financed, partially state funded, or one big partnership.

While there are certainly many variables to consider aside from those mentioned above, we at RSW believe that an obvious and meaningful omission from the conversation is the real time economic drag caused by the recent surge in interest rates. Mortgage and refinancing activities, credit cards, car loans, home equity loans, and the need to roll over some portion of Corporate America’s exploding debt at much higher rates are headwinds that are here, real and substantial. So too, there is little talk of the dollar's revived uptrend that retards economic growth (US exports become more expensive) through diminished trade and impaired multinational earnings.

Two recent economic events provide examples of what can seem economically certain, were priced-in by the market as such, but were turned out not to be a "slam dunk". When oil collapsed from $100+ to the high $20 range per barrel, we were barraged with predictions of improved consumer spending and economic growth by the defacto "massive tax cut". The market chose "heads" and ignored the "tails" of the financial impairment to the energy companies. Forgotten about were the thousands of high paying energy jobs that were lost, which led to diminished spending power. In short, the market didn't "net out" the economic benefits and the unintended casualties of the move in oil prices. Not only were the predictions of enhanced growth too optimistic, economic growth actually declined slightly from the already slow pace of activity.

In terms of fiscal spending, as we recall, there is an example that holds some relevance on this topic. When the Japanese equity market crashed in the late 1980's, the Government undertook fiscal stimulus packages much like after our Great Recession. Every year since 1990, the Japanese Government has supplemented

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their economy with a fiscal stimulus package. This has continued up to and including 2016, and has not succeeded in changing their structural growth or inflation curve. Many would argue that Japan is different than anywhere else. We would argue that the laws of economics do not cease at Japan's border. The combination of declining or stagnant population, low productivity, and high debt to GDP are powerful forces that are not easily reversed by monetary or fiscal policies. Unless Japan or the Western Nations can make old people young again, or make low productivity rise, or make huge debt burdens shrink, the world's growth machine will labor.

We hope that this communication has not come across as an argument to say that the economic environment can't change from its current morass. It's just that it is far from a given, and not in synch with our base case. We all must use caution so as not to "cherry pick" facts that support our views. The potential for reflation, infrastructure spending, repatriation of cash, lower corporate and individual tax rates are all real promises made. But so are President Elect Trump's promises to throw out NAFTA and TPP, to declare China a currency manipulator, and threatening Mexico with retaliation and tariffs, which collectively would diminish the positive effects of tax cuts and fiscal spending.

Aside from the political risk, the US Treasury bond market has responded to a belief that inflation expectations have bottomed. At RSW we share the same view, with the caveat that a lasting shift is not a given. It appears that the market has re-priced inflation expectations upward for two reasons. First, the price of oil bottomed in January of 2016 from $26 a barrel to today's level of $54. This has the affect of causing the headline inflation rate to rise (historically if that doesn't translate into higher wages it's actually long term deflationary). Without higher wages, any uptick in essential or non-discretionary items zaps consumer discretionary spending and sows the seeds for a continuation of the deflationary trend. The second reason is Trump's policies which have more broadly discussed in this commentary.

RSW's base case scenario is that the bond market has already priced-in a significant portion of Trumpenomics. More success than presumed or the spread of inflation to wages could cause another leg up in interest rates. On the other hand, a delay in policy passage, its diminished size, or weakening growth (probably caused by the latest yield surge) could cause rates to ease. With that said, we don't take issue with the financial markets projecting an overall positive outcome from Mr. Trump's policies. It's just that a "Heads I win, Tails You lose" posture seems premature.

Looking Ahead: 2017 Base Case Forecast

Interest Rates: Any yield rise (US 10 Year Treasury Note) should be capped at 2.80%

GDP: 1.90%

Inflation: 1.50% (as measured by the Core PCE (Personal Consumption Expenditures Index) excluding food and energy)

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Municipal Bond Commentary: Rates and Ratios Matter

Treasury Market Review

Entering 2016, we had two beliefs regarding interest rates. First, that any upside surge in Ten-year maturity (market barometer) US Treasury Notes (yielding 2.27% at 12/31/15), should not exceed 2.75%. Second, that bond yields had room to fall precipitously. During the year, US Treasury yields collapsed with the Ten-year Note falling to a cycle low of 1.35% in July. Since then, rates have moved in a straight line higher and have gone parabolic post election. In fact, yields tacked on another 60 basis points (0.60%) since November 9 to stand at today's level of 2.43%.

Tax-Exempt Market Review

Tax-exempt bonds entered the year toward the more "expensive" part of their historical averages when compared to US Treasury bonds. The "ratio" as it is often referred to, compares the yield relationship of the two bond markets. For example, on 12/31/15, using ten year maturity "AAA" rated tax free yields as a proxy, tax-exempt municipal bonds were valued at 85% of comparable maturity US Treasury securities (add actual yield numbers). During much of the year, the municipal bond market predictably fluctuated in tandem with the yield movements exhibited by the US Treasury bond market.

Then there was November 9.

Correlations between tax-exempt's and Treasury bonds broke down, as Trump's victory began to re-price the financial markets with the expectation of "Trumpenomics" . As US Treasury and municipal bond yields soared, many individual investors (who own the majority of the outstanding municipal bonds) responded by liquidating their municipal bond mutual funds. To meet these redemption requests, mutual fund portfolio managers were "forced" to sell tax-free securities into a declining market. These activities served to exaggerate the price declines as the pace of selling dwarfed the broker/dealers appetite to add to their bond inventories. The ensuing supply-to-demand imbalance forced the ratio to spike, causing tax-exempt yields to reach a high of 108% of comparable maturity Treasury bonds. Today, this ratio, while historically elevated, has meaningfully declined, and now stands at approximately 96%.

For all of the factors discussed in the "Heads I win, Tails you lose" section, we are in general maintaining a cautious approach. For much of the year, the duration (measure of interest rate sensitivity) positioning of our client portfolios has been shorter than our historical average. From here, we believe that the risk of higher tax-exempt rates has been partially mitigated due to the relative attractiveness of the municipal bond asset class.

Specifically, we believe that 10-year maturity tax-free bonds are already valued (priced) as if comparable maturity Treasury bonds are yielding 2.75% (assuming a more normalized ratio). Therefore, with yields already at elevated levels and ratios in the "cheaper part of the range", we are inclined to modestly loosen our interest rate risk exposure.

At this juncture, we thought that it would be instructive to illustrate RSW's projected total rate of returns for the Market and Low Duration strategies assuming interest rates shift up or down by 25 basis points (0.25%), 50 basis points (0.50%) and 100 basis points (1%).

Estimated Annual Total Rate of Returns

Interest Rate Assumptions	Hypothetical Market Duration Portfolio	Hypothetical Low Duration Portfolio
Decline by:		
25 basis points (0.25%)	3.62%	2.18%
50 basis points (0.50%)	4.47%	2.52%
100 basis points (1.00%)	6.22%	3.21%
Rise by:		
25 basis points (0.25%)	1.93%	1.51%
50 basis points (0.50%)	1.10%	1.18%
100 basis points (1.00%)	-0.53%	0.52%

The hypothetical returns shown above were calculated using the InvestorTools Perform system. The analysis assumes a static 25, 50, and 100 basis point parallel shock to the Municipal yield curve in both directions over a 12-month time period. In addition to the price and yield components of total return, "roll down" the yield curve is also considered as bonds become one year closer to maturity during the one-year time period the analysis considers. Portfolios were priced as of 12/12/16.

It is important to note that the longer the holding period the less impactful a rise in interest rates is to the total rate of return of the portfolio. The passage of time allows for the coupon income (cash flow) and benefit of "rolling down the yield curve" (This topic was discussed in RSW's white paper entitled "slope of Enhancement" https://www.rswinvestments.com/wp-content/uploads/the-slope-of-enhancement-rolling-down-the-yield-curve.pdf) to cushion the portfolios' market value against price erosion caused by higher interest rates.

When it's all said and done there are questions that investors need to ask themselves:

Q: Why do I own bonds?

A: Investing is not about what happened, it's about what happens from today forward.

Q: Am I invested in the municipal bond asset class to capture the next 25-50 bps of price appreciation?

A: Generally I am invested to capture a steady stream of tax-exempt cash flow, and counterbalance my inherently riskier assets in an increasingly risky world! (RSW suggested answer).

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