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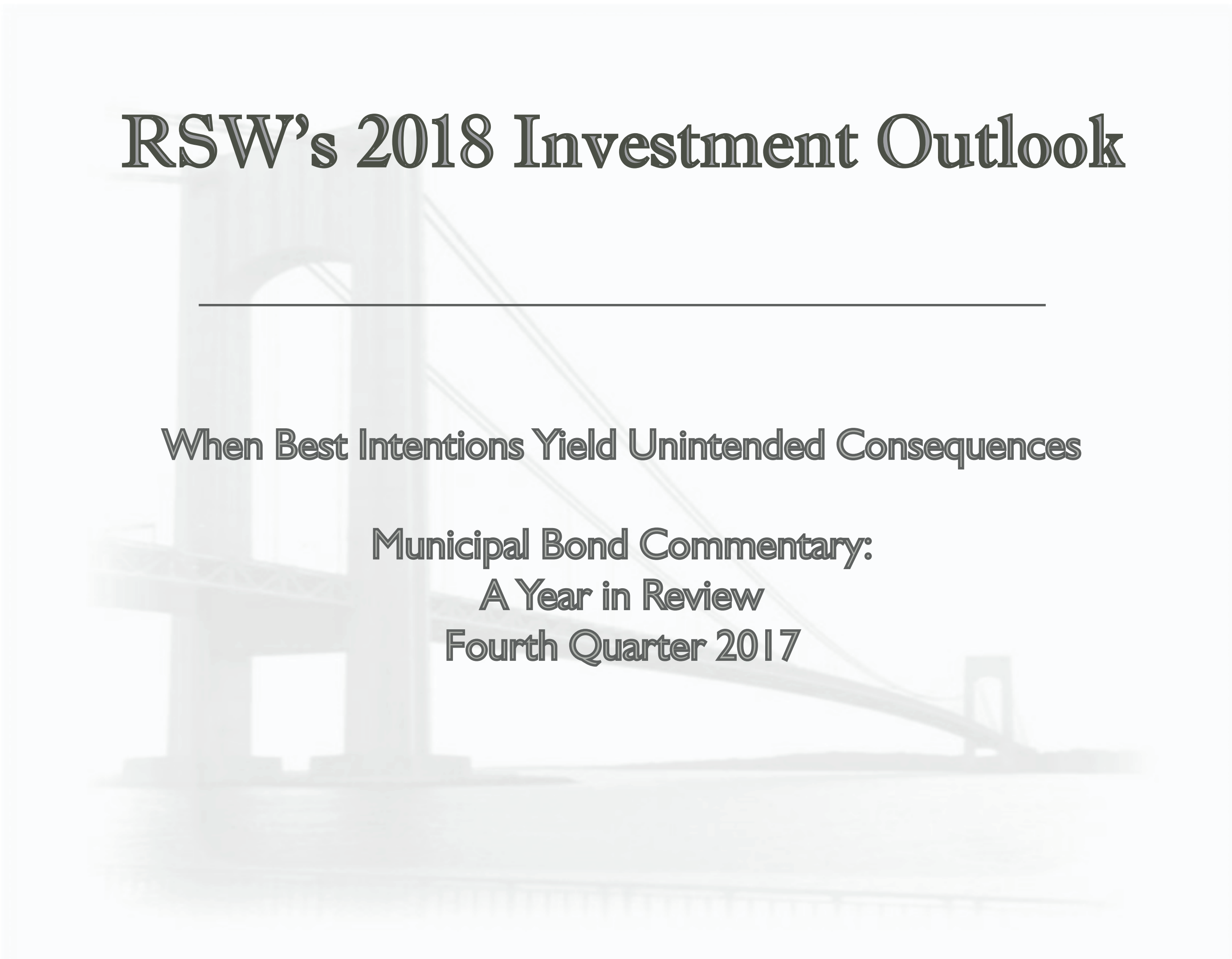

RSW's 2018 Investment Outlook

When Best Intentions Yield Unintended Consequences

Municipal Bond Commentary:
A Year in Review
Fourth Quarter 2017

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When Best Intentions Yield Unintended Consequences (1/5/18)

Happy New Year! We have closed the books on 2017 and it is now incumbent upon us to score our forecasts versus the year's actual economic data.

Interest Rates:

Forecast: Any yield rise (U.S. 10 Year Treasury bond) should be capped at 2.80%
Correct: 10 Year U.S. Treasury bond yields peaked at 2.64%

GDP:

Forecast: 1.90%
Wrong: Real GDP is likely to come in at 2.50%.

Inflation:

Forecast: 1.50% (As measured by the Core PCE [Personal Consumption Expenditure Index] excluding food and energy)
Correct: Actual Year over Year PCE 1.40%

As we entered 2017, RSW's base case scenario was that the bond market had already priced-in a significant portion of "Trumpenomics". This proved to hold true as the passage of tax reform legislation, improving GDP and the prospect for a massive infrastructure spending bill did not rattle the bond market. In fact, the yield change for 10-year U.S. Treasury bonds scored its lowest level of fluctuation in the last 65 years.

Will Goldilocks Get Flattened by the Curve?

While we always attempt to make our correspondence topical and relevant, this musing will hopefully be even more so as many of you participated in drafting it. As returns in the riskiest asset classes have exceeded their norms and economic data points to faster growth, one important bond market indicator, a "flattening of the yield curve", is flashing a yellow warning signal. This is an important indicator that doesn't fit the "Goldilocks" scenario and when combined with tax reform, has sparked many phone conversations regarding asset allocation.

Possibly the most universally accepted warning of an economic slowdown has been a "flattening of the yield curve". As the Federal Reserve has been steadily hiking the Federal Funds Rate (overnight rate), the yield differential between shorter and longer maturity bonds has narrowed markedly (flatter yield curve).

In fact, during 2017, 10-year bond yields were relatively unchanged, falling 5 basis points (2.45% versus 2.40%) while interest rates on two-year bonds spiked higher by 70 basis points, climbing from 1.19% to 1.89%.

This interesting dynamic of declining long-term interest rates, coinciding with increasing short-term rates was mentioned by the then Fed Chairman, Alan Greenspan in February 2005 and dubbed by him as a "conundrum". In RSW's Q2 2005 Commentary we wrote: *"Conundrum? We find the Chairman's conundrum comments to be remarkable, since he has simultaneously pushed up the Federal Funds Rate by 225 basis points and testified that the underlying inflation rate is expected to be contained. Can these two dynamics have any other impact than to flatten the yield curve?".* Today's pace of inflation also looks well contained. Is the Federal Reserve about to repeat their mistakes of the past?

While it may be considered a "conundrum" for some, for us at RSW, it's a distinction without a difference. The real damage from a flattening yield curve is that it greatly reduces or eliminates the profitability of lending activities. As the difference in interest rates between where banks can borrow and lend funds contracts, they are less incentivized to make loans as the narrower yield differential erodes the potential for profit. This typically results in a credit contraction, where a lack of available loans is often enough to tip an economy into recession.

Today, from our vantage point, there are similarities to the 2005-2006 period, as rising inflation wasn't a threat and the abundance of indicators did not point to meaningful economic weakness, much less a recession. Similarly today, economic weakness is scant, but the yield curve continues to flatten. Remember, the last two recessions were caused by financial events rather than by economic fundamentals such as decreasing consumer demand, production cuts, or a surge in job losses.

With an estimated increase of over $70 trillion in total debt over the last ten years, the global economy has become even more highly leveraged than it was in 2007. As a result, we believe the economy is even more vulnerable to financial shocks today. Only now, in this atmosphere of "Goldilocks" markets, are we being told by the pundits and "talking heads" that the flat yield curve is not a cause for concern. In fact recently, professionals have offered explinations for the flat yield curve, suggesting that this phenomenon is a product of a worldwide savings glut and the related search for higher yield (longer maturity bonds). This is similar to comments we heard back in 2005 & 2006, the last time the curve was flat/ inverted. Like then, we need to be mindful that bond markets have a good track record for sniffing out "problems", and at this moment they seem to be telling us something.

Winners and Losers, Forget the Broad Brush!

While most of our conversations have been focused on outsized global returns and related risk, the passage of tax legislation has made it even more timely. The overwhelming consensus that this tax bill will enhance growth is so common, that only the extent and sustainability of GDP growth are debated. We are not attempting to make a counter argument that some economic growth shouldn't emerge, only that unintended consequences of a bill this substantial are both likely and difficult to forecast.

Aside from unpredictability, the unintended consequences are even more likely to affect entities within each asset class differently, producing unlikely winners and losers. The following examples should serve to highlight this point. The new 21% corporate tax rate holds great promise of increased profitability for corporations. With that said, the effective tax rate for Coca-Cola Co. last year was only 19.5% (Fortune Magazine), while Dr. Pepper Snapple Group paid Uncle Sam a rate of 33.8%. In addition, very little attention has been given to a provision in the tax reform bill that caps a corporation's deductibility of interest expense at 30% of adjusted taxable income greater than $25 million. So, for those companies that are financing their operations with high levels of debt, it is likely that they should be visible losers when considering the new tax plan, even if they are operating within a favored industry.

The topic of “Winners and Losers” can also be extended to the municipal bond asset class as various provisions of the bill affect each state’s finances unevenly. Specifically, the newly enacted tax reform legislation dramatically alters the Federal/State relationship that has existed relatively unchanged since the introduction of the income tax in 1913. A “cap” on the deductibility of state income and local property taxes (SALT) at $10,000 from federal tax returns, represents an unprecedented sea change with consequences for “high tax” states (NY, CA, NJ etc). So much so, that for high income earners living in high tax states, it is likely that the effective tax rate will probably increase (consult with your accountant) despite a reduction in the top individual tax rate from 39.6% to 37%.

This will present significant challenges for the states highlighted above as they will now have less flexibility to raise their own state tax rates to close fiscal budgetary imbalances. Increasing state taxes, could, to various degrees, cause an outmigration of higher income and productive labor force populations to lower tax states. History has shown us that the wealthy have the financial means to “flee” to lower tax states, and therefore are the most likely to do so.

While we are only talking about the top 1% of wage earners, they pay an outsized percentage of the states’ expenses. At this juncture, it is difficult to say how this will “net out". However, one thing is clear, a disproportionate amount of high income earners reside in California, New York, New Jersey, Massachusetts, Connecticut, Pennsylvania, and Illinois. Furthermore, the potential for housing values to fall in these states (particularly at the higher end) is increasing, and with those declining values come ripple effects to the broader economy. This serves as just one example of unintended consequences previously discussed.

The phrase, “Double Edged Sword” applies here. Although it is likely that financial troubles for high tax states are about to get worse, it is also likely that demand for bonds issued in these states may become more popular. Specifically, some investors may opt to abandon a municipal portfolio that is state diversified and instead elect for a more concentrated approach, emphasizing issuers in their state of residence.

What You Think You Know, You May Not Know

In RSW's Q4 2016 commentary, we highlight the folly in attempting to handicap political risk. Forecasting changes to the supply to demand dynamic in the municipal bond market serves to highlight this point. Back in the Summer of 2017, the biggest concern on the minds of tax-free investors was the likelihood of a tax reform bill eliminating all tax-exempt bond issuance. Followed by, how much would tax-exempt bond prices fall (yields rise) if the top tax rate was slashed to 33%?

As it turns out, components of the new legislation (outlined in the "Municipal Bond Market Commentary" below) weren't even in the public ether and therefore not even discussed prior to November 2017. Furthermore, the final version of the tax bill is for the most part, municipal investor friendly and not a cause for panic. When it is all said and done, Municipal bonds should continue to be viewed as an asset class that provides comparatively attractive levels of after-tax cash flow, relatively strong credit quality, liquidity and traditionally has been negatively correlated with riskier asset classes.

Conclusion

According to the pundits, 2017 should have been the break-out year for longer-maturity bond yields. However, we saw rates barely budge after passage of a sweeping tax reform bill expected to cost $1.5 trillion over ten years, a quicker pace of GDP growth, lower rate of unemployment and the talk of a $1 trillion infrastructure spending bill. What does that imply for 2018? We believe more of the same, but with perhaps greater yield fluctuations than we experienced during 2017.

Although the yield curve is flattening and not yet inverted (short term rates higher than longer term bond yields), we think it is important to reflect on the dynamics that existed in 2005. Specifically, in RSW's Q4 2005 commentary we stated: *"There have only been rare instances where the yield curve has inverted, and a recession did not occur."* Additionally, we said: *"The Fed stated that they believe this time to be different and have publicly discounted the yield curve's predictive ability as an economic indicator"*. Sound familiar? That's what they are saying this time as well.

We believe, that in the absence of wage inflation, the Federal Reserve is fighting a demon (sharply higher rates of inflation) that doesn't yet exist. It is certainly possible that the Fed is again misreading the economic tea leaves by "overtightening" and fulfilling the true definition of insanity, doing the same thing over-and over-again, expecting different results.

As mentioned earlier, our conversations regarding asset allocations are topical and relevant, and possibly more so now than in recent history. Similar conversations were had in 2006 when we wrote: *"With history as our guide, one can only assume that the Fed will continue raising rates until a hard economic landing is apparent. As far as inflation is concerned, we continue to believe that the concern remains overblown, and that the Fed is fighting an enemy that has failed to show up on the battlefield."*

On a daily basis, we all need to decide if we shift our portfolio structure, bet against or stay the course. None of what we have said precludes the natural "tweaking" of a prudent asset allocation discipline. Our recent short duration stance was such an example. What should be challenged, is the mentality most often associated with markets that move in one direction. During these "everyone owns the hot assets and I don't" periods, the importance of diversification may be difficult to appreciate. Only when the financial conditions become unfriendly do we fully recognize it's true worth. Looking ahead, our base case prognostications are as follows:

Interest Rates:

Forecast: Any yield rise (U.S. 10-Year Treasury bond Yield) should be capped at 2.90%

GDP:

Forecast: 2.30%

Inflation:

Forecast: 1.65% (As measured by the Core PCE [Personal Consumption Expenditure Index] excluding food and energy

Municipal Bond Market Commentary

A Year in Review

Notwithstanding the spike in tax-exempt bond yields that occurred in post-election 2016 and the concerns of a continued bond market rout, the municipal asset class scored solid total rates of return. However, not all maturities behaved the same. Longer maturity bonds outperformed shorter maturity bonds by a wide margin. Specifically, yields on 20-year "AAA" rated bonds declined by (-47) basis points compared to (-11) basis points for 5-year tax-exempt securities (Source: Municipal Market Data).

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The prospect of a tax reform bill brought with it a deluge of new issue supply. The volume of new bonds sold in November and December will end up totaling almost 25% of the year's aggregate issuance. This supply surge caused a high level of yield and corresponding price fluctuations, during a year previously characterized by low volatility.

In effect, Municipal Issuers "pulled forward" financing transactions that were slated for sale in 2018, as they rushed to beat the elimination of advance-refunding transactions. With the passage of tax legislation, municipalities are precluded from issuing bonds for "advance- refunding" (refinance) purposes. These transactions afforded municipalities the ability to capitalize on a declining interest rate environment by issuing new lower rate bonds. The proceeds of the issuance were used to retire higher yielding outstanding debt ahead of the bonds first call date.

By eliminating advance-refunding issuance, forecasters are anticipating a substantial contraction in new municipal bonds offered in the marketplace. Lower levels of supply and the prospect of continued strong investor demand, should set the table for a strong technical environment. This should hold true, despite the possibility of reduced corporate demand for tax-exempt paper due to lower marginal tax rates (corporate tax rate reduced to 21% from 35%).

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