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RSW's 2015 Investment Outlook

Charge of the Central Bank Brigade

Implosions without Collateral Damage

RSW Investments, LLC ▪ 47 Maple Street, Suite 304 ▪ Summit, NJ 07901-3647 ▪ (908) 608-9600
www.rswinvestments.com

Charge of the Central Bank Brigade (12/15/14)

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It can be said that major economies around the world have entered into a "currency war," with the battlefield comprised of central banks and economic policy makers.

"Emerging-market countries will be alarmed at the increasing strength of the U.S. dollar against their local currencies and will try to fight back by weakening their own money."

The recent collapse in oil prices is a symptom of weak global economic activity and related demand (or lack thereof). Historically, lower-energy costs have served to boost consumer spending. While over the near term this may prove to be the case, this time is different.

Contrary to "conventional wisdom," RSW does not believe that the Federal Reserve raises the level of short term interest rates next year.

We believe that any meaningful rate advance would be unsustainable and prove to be a gift for bondholders.

Happy Holidays! It's that time of the year again when we look in the rearview mirror and score our prognostications versus the actual events of the year.

The Year in Review

We "bucked the trend," and stood apart from the "crowd" who maintained their prophecy for stronger economic activity, inflation, and higher interest rates.

What we got right!

- ✓ In 2014, inflation should continue to fall as consumers' spending shrinks.
- ✓ Bond yields will resume their decline.
- ✓ Wage growth will remain tepid.
- ✓ Puerto Rico debt will no longer be rated investment grade.
- ✓ The municipal yield curve will "flatten" (long bond rates will decline at a faster pace than shorter-maturity bond yields).
- ✓ Volume of new issue municipal bond supply will continue to be significantly less than the ten-year average.

Tweener: We called for GDP to remain below 2% in 2014. If we average the first three quarters reported thus far in 2014, the growth rate stands at 2.13%.

What we got wrong!
Nothing really.

Prognostications

Interest rates
The world is askew and while one's guard should always be up to anticipate "left field" events and heightened volatility, we all need to be more vigilant today. Our minds are wide open to the possibility that interest rates could rise due to some unforeseen event. With that said, because of the conditions outlined in this musing and others since 2006, we believe that any meaningful rate advance would be unsustainable and prove to be a gift. Why? Please see points below, and read on…

- ✓ Disinflation/deflation will worsen as the U.S. "imports" deflation from overseas.
- ✓ The global economic contraction in the developed world will begin to weigh on the U.S. economy.
- ✓ 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%.
- ✓ Municipal bond prognostications can be found in the municipal section following entitled "Implosions without Collateral Damage."

"War is too important to be left to politicians. They have neither the time, the training, nor the inclination for strategic thought." – Dr. Strangelove (1964)

Deflationary predicament
In order to fully appreciate the scope of the challenges in our economic system returning to "normalcy," let's first revisit the 1970's, and then take a tour around the globe. As you may recall, (if you are a "fossil" like some of us), during the early to middle part of the 1970's, the Federal Reserve maintained an interest rate policy that was highly "dovish," or accommodative. This strategy set the stage for a punishing 15% year-on-year increase in the rate of inflation. Concurrent with an inflation rate that had not been witnessed in over one hundred years, came a nearly 22% decline in the value of the U.S. dollar.

In contrast, today our nation's central bank is far more aggressive than back in the earlier 1970's to promote economic growth. It could be said that we are in "the horns of a dilemma" as Bernanke "threw his printing press from a helicopter," racked up a $4 trillion balance sheet, maintained short-term interest rates near zero percent, and inflation still hasn't awoke from its slumber. Unfortunately, this deflationary predicament is true for many of the economies in the developed world.

Despite the most massive global monetary stimulation that we have witnessed in the last two centuries, inflation and growth are faltering. Here at home, a study by the St. Louis Fed reveals that there are "dramatic increases in the private sector's willingness to hoard money instead of spend it." For years now, the Federal Reserve, along with most pundits and economists has anticipated the imminent return of inflation, but it hasn't risen to the occasion.

Many pundits who thought that International Quantitative Easing would spark shockingly high levels of inflation were just wrong. Instead, deflation is in the air, and it doesn't seem to be dissipating, but instead gathering momentum.

I want my GDP!

As we review the global pace of Gross Domestic Product in the developed world, it becomes apparent that economic activity is hovering at or below "stall speed." To begin, growth in the Eurozone has been stuck in the mud, and unable to gain traction. According to the OECD (Organization for Economic Cooperation and Development) the Eurozone economy is smaller now than it was at the beginning of 2012 and still hasn't approached its pre-crisis level.

While all eyes are usually glued to the poor economic conditions unfolding in Portugal, Ireland, Greece, Spain and Cyprus, these countries only comprise roughly 20% of the Eurozone's GDP. The real story that is unfolding concerns the Eurozone's three largest economies. Namely: Germany, France, and Italy (largest to smallest).

Germany:
- *Bundesbank expects gross domestic product to be 1.4% in 2014, down from a forecast of 1.9% in June.*

France:
- *According to INSEE (French National Institute for Statistics and Economic Research), growth is expected to be only 0.40% in 2014, roughly the same as in 2012 and 2013.*

Italy:
- *Has fallen back to recession for the third time since 2008 and is projected to remain a drag on Eurozone growth for the rest of the year.*

Similarly, growth prospects are folding in many parts of the developed world, with numerous countries on the precipice of an economic contraction. On December 2nd, Bloomberg reported that Russia is "entering a recession." The economy is stumbling due to a weak European economy, penalties imposed over the conflict in Ukraine, and a nearly 40 percent drop in oil prices, which is weakening export revenue. China's economy is also slumping as housing sales, prices, and manufacturing activity is falling. Gross domestic product expanded by 7.3% in the third quarter versus the same period last year, which is the weakest performance since the global financial crisis began.

The global economic contraction and related decline in the rate of inflation throughout Europe and Asia is causing central bankers to become increasingly concerned. Specifically, Eurozone inflation dropped to the lowest level since the worst of the global financial crisis. Falling prices are heaping pressure on the European Central Bank to go even further to avert the threat of deflation. Furthermore, while Japan is at the doorstep of deflation in Asia, producer prices are also falling in the Philippines, Singapore, South Korea, Thailand, and China. In short, deflation is engulfing nearly every major economy in the world, and seems to be pulling prices down across the board. What can be done to combat this rare phenomenon?

Tactics

Against the challenging environment outlined above, currency devaluation strategies seem to be all the rage. Interest rate cuts, negative deposit rates (European Commercial Banks must now pay the central bank interest to "park" its funds there), and asset purchases (QE) are just some of the actions that jurisdictions are enacting to combat deflation, and win a bigger share of anemic global growth.

In November, central bankers called in reinforcements. Japan, Europe and China all took unanticipated actions to inject various types of stimulus into their economies. For additional support, the European Central Bank issued a statement on November 21 saying it would "broaden even more the channels through which we intervene." While these actions are normally discussed in the context of their effect on interest rates, the impact to the value of a nation's currency is perhaps more profound. In fact, it can be said that major economies around the world have entered into a "currency war," with the battlefield comprised of central banks and economic policy makers.

Charge!

By flooding the financial system with their local currency, central banks are competing to drive down the value of their "home" currency in order to spark an increase in the pace of their exports. Remember, as a country's currency declines, the price of its goods abroad concurrently falls. This has the goal (not always attained) of increasing employment as demand for their "cheaper" goods rises in the global marketplace. Sounds so simple, but the result of debasing one's currency is a "zero-sum" game. If one currency weakens, another currency strengthens, and if one country's trade balance improves, another's worsens.

So, there is a downside to this strategy. First, with a weakened currency, the cost of imports becomes more expensive thereby hindering the purchasing power of its citizens. Furthermore, if the devaluation is severe enough, those actions may provoke a retaliatory response by the other countries. To this end, please see below for a collection of headlines found in recent periodicals:

> *"Australia under pressure amid new currency war"*
>
> *"Emerging-market countries will be alarmed at the increasing strength of the dollar and other developed world currencies against their currencies and will try to fight back by weakening their own money"*

"If both Japan and the euro area go for extensive QE, emerging markets in Asia would suffer as their currencies appreciate. There would be no way China could restart its sputtering growth engine without major yuan devaluation"

"The clear danger is that China will feel compelled to defend itself by devaluing thereby throwing its huge weight into a beggar-thy-neighbor battle across East Asia"

"Should that happen, the mother of all deflationary shocks will roll over Europe before the EU authorities have even got out of bed".

"Japan risks Asian currency war with fresh QE blitz"

Effects on Outstanding Debt

Countries with high debt levels also prefer to see the relative value of their currency decline. Debts owed to a country that devalues its currency become cheaper for debtor countries to pay. For example, if the U.S. owed China a debt in yuan, and the Chinese government devalued the yuan, it would become less expensive for the U.S. to buy yuan, making the debt less expensive to pay. On the flipside, if the debts were denominated in U.S. dollars instead of the devalued currency, the devaluation would increase the debt.

Half a League, Half a League

The global economy today has clearly entered a transitional stage. A further contraction in Europe and Japan, which is quite likely in months to come, may prove sufficient to drag a number of emerging economies with it. That in turn would slow growth in both the U.S. and China economies. But for now, low inflation has become the central challenge to turn around the Eurozone economy, with sluggish demand from households and businesses keeping prices low. Should the pace of deflation worsen (RSW's base case forecast), a sustained period of falling prices would become embedded in the economy. This acts as a tripwire as businesses and households may delay purchases, further depressing demand, employment and growth. As we have mentioned on numerous occasions, central banks lack the ammunition to fight such a trend once it takes hold.

MUNICIPAL COMMENTARY

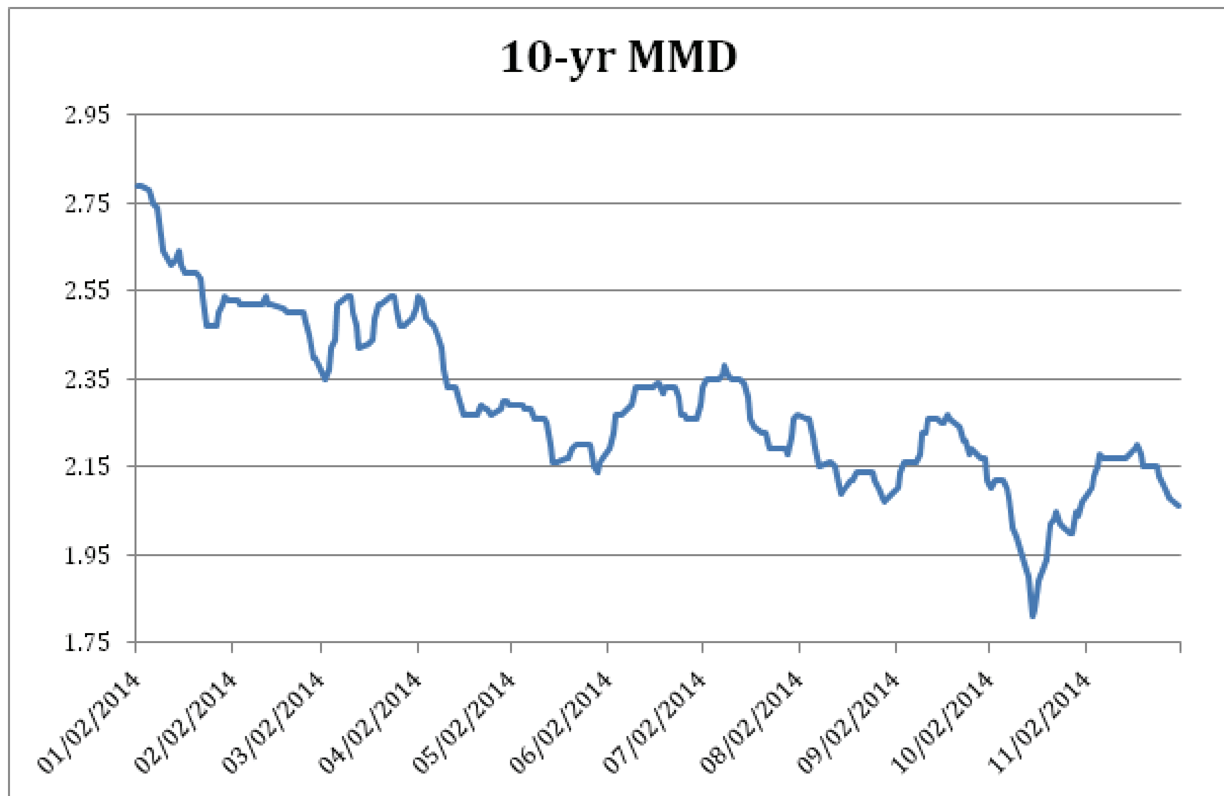
Implosions without Collateral Damage

2014: The Year in Review

- The year 2014 witnessed the largest implosions in the municipal market since the default of $2.5 billion of Washington Public Power Supply System revenue bonds back in 1984.
- Nevertheless, with all due respect to the holders of bankrupt Detroit bonds and the $70 some odd billion of now "CCC" to "C"-rated Puerto Rico paper, the impact of these implosions on overall

municipal market pricing, valuations and credit were non-existent. Specifically, this is also the case for RSW clients whose portfolios never have included these bonds.

- To some degree this is easily demonstrated by the relatively steady downward march of tax-exempt yield levels over the course of 2014 to higher bond prices. There were no "Meredith Whitney" spikes in yields or "windows of opportunity" attributed to these implosions.



- In our 2014 Outlook we stated that the Detroit bankruptcy would have minimal impact on the market and that junk bond status, debt restructuring and market access would be hurdles for Puerto Rico.

- For 2015 we see no viable intermediate or long term solutions for Puerto Rico. Various Band-Aids and fingers in the dyke will keep the Commonwealth functioning in order to provide minimal essential services.

- Our 2014 Outlook also expressed concerns for legal challenges that would reverse pension reform in Illinois. This has come to pass as the state court threw out the previously passed reforms. We are now

awaiting the appeals to the State Supreme Court. Affirmation of the lower court decision would result in further multiple downgrades of the state and conceivably the city of Chicago.

- On a positive note, a year ago we recognized the reversal of red ink in California but expressed concern with forthcoming pressures on a newly elected state legislature to restore previously enacted draconian budget cuts despite the need to build up depleted reserves. We have been pleasantly surprised by the state enacting new legislation based on a voter approved proposition to mandate a buildup of reserves over time from specific levels of capital gains tax receipts. If California can adhere to this legislation it would go a long way in minimizing the historic volatility of its credit ratings and therefore the valuations of the state's bonds.

- We had also expressed concern about the ability of the newly elected New York City Mayor DiBlasio's ability to incorporate approximately $8 billion of retroactive pay raises in the administration's budgets in addition to other pressures including rising pension costs. Here, the jury remains out.

Looking to 2015: Municipal Debt Issuance Will Continue to be Less Than Robust

- By virtue of all measures of "technical analysis," municipal new issue volume will continue on a trend line of being below average. Through November 2014, new issue volume of approximately $295 billion was 4% lower than volume for the same period last year. Compare this to 10-year average of new issue volume of approximately $380 billion (Securities Industry and Financial Markets Association).

- Bonds issued for "new money projects", minus debt issued to refinance existing higher interest rate bonds, totaled only $130 billion during the first 11 months of 2014, 9% lower than the same period last year. More telling, it is approximately 30% lower than the 10-year annual average of new money issuance.

- There is nothing on the horizon for 2015 to suggest that anything will change that would alter this trend of stagnant or below trend bond issuance.
  - Fiscal restraint is the "buzz word" of the day for state and local governments.
  - A cursory review of fiscal year 2015 state budgets does not reveal any uptick in debt issuance as revenues remain constrained and other budgetary pressures prevail, most notably pensions and health benefits.
  - Republicans dominate local and state elections- to the extent politics are indicative of fiscal

constraint. Republicans now control both houses of state legislatures in 29 states, the highest number since 1920. Democrats control both houses in only 11 states. There are 31 Republican governors.

- To make matters worse: It is estimated that $387 billion of bonds and notes (MuniView) were redeemed, that is they matured or were called in 2014. This is approximately $60 billion more than the year's estimate of new bonds brought to market. We anticipate that this trend will continue, if not accelerate, during the course of 2015.

Robert S. Waas Managing Member	Robert S. Coates Senior Portfolio Manager	Matthew T. Werner Portfolio Manager	Mark J. Tenenhaus Director of Municipal Research	Stephen R. O'Donnell Director of Business Development	Marites V. Pasturan Data Analyst	Randy J. Fox Operations Associate	Brian E. Pawl Operations Associate

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