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RSW's Q1 2015 Fixed Income Newsletter

"Fed-Up" : Losing Patience with the Patient

Tax Exempt Commentary

State Tax Receipts: Uneven Performance

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"Fed-Up": Losing Patience with the Patient (4/17/15)

- *The next time personal income or hourly wages are released and they beat or miss the estimated figure by one or two cents per hour, remember this discussion.*

- *The next time Janet Yellen is asked a question about wages and she responds that the problem is more secular, remember this discussion.*

- *And, the next time some PhD writes a white paper discussing this phenomenon, remember you saw it here first.*

- *You don't need to be a brain surgeon to deduce that we are turning out more bartenders than brain surgeons.*

- *On March 18th, the word "patient" disappeared along with the Fed's recent assertions of a sustainable recovery.*

- *Due to the low participation rate, today's unemployment rate of 5.50% may mirror a 7.50% to 8.00% rate.*

- *The bottom 60% of wage earners have literally seen their real wages (household incomes, after inflation) stagnate, not since The Great Recession, but for the last 50 years.*

- *Akin to many countries around the globe, debt levels have mushroomed, and the higher rate on that inflated debt simply becomes unaffordable.*

We will confess from the outset that we did not intend to make the Q1 discussion about structural (referred to as Secular Stagnation by Larry Summers) economic issues. While we are "FED-UP " with this topic, we must admit that the "devil" didn't make us do it, Janet Yellen did!

In presenting our analysis and concepts in this commentary, we found that the late Supreme Court Justice Potter Stewart's words fit surprisingly well here. When asked during a case (*Jacobellis v. Ohio*) how to define hard core pornography, he quipped that he wasn't sure if he could define it, "but I know it when I see it!" At RSW, we probably could not define Secular Stagnation either, but we have come to know the concept well and report it when we see it.

For much of the first quarter, conversations about what the Fed may or may not do dominated financial market conversation. At the forefront was the Federal Reserve's March meeting. Specifically, market participants stressed about whether the Federal Reserve will or will not remove the word "patient" before acting to raise the level of short term interest rates. In "Yellen-speak", this indicates that they will hold off increasing interest rates for at least two meetings.

On March 18th, the *word "patient" disappeared, along with the Fed's recent assertions of a sustainable recovery.* In summary, the Fed lowered their median GDP estimate through 2017 by approximately 0.40%, and expects growth will fall into the 2.30% - 2.70% range. Additionally, anticipated growth from 2018 and beyond is expected to drop to the 2.00% - 2.30% area. As we have noted in the past, the Federal Reserve's economic forecasts have been poor, but consistent. Since 2008/9, not only have their growth estimates continuously missed the mark, but their errors have occurred because their prognostications have always been too high, never too low. Here's a tip for those betting on the Fed's growth predictions: take the under!

Does the Unemployment Rate Explain the Health of the Job Market?

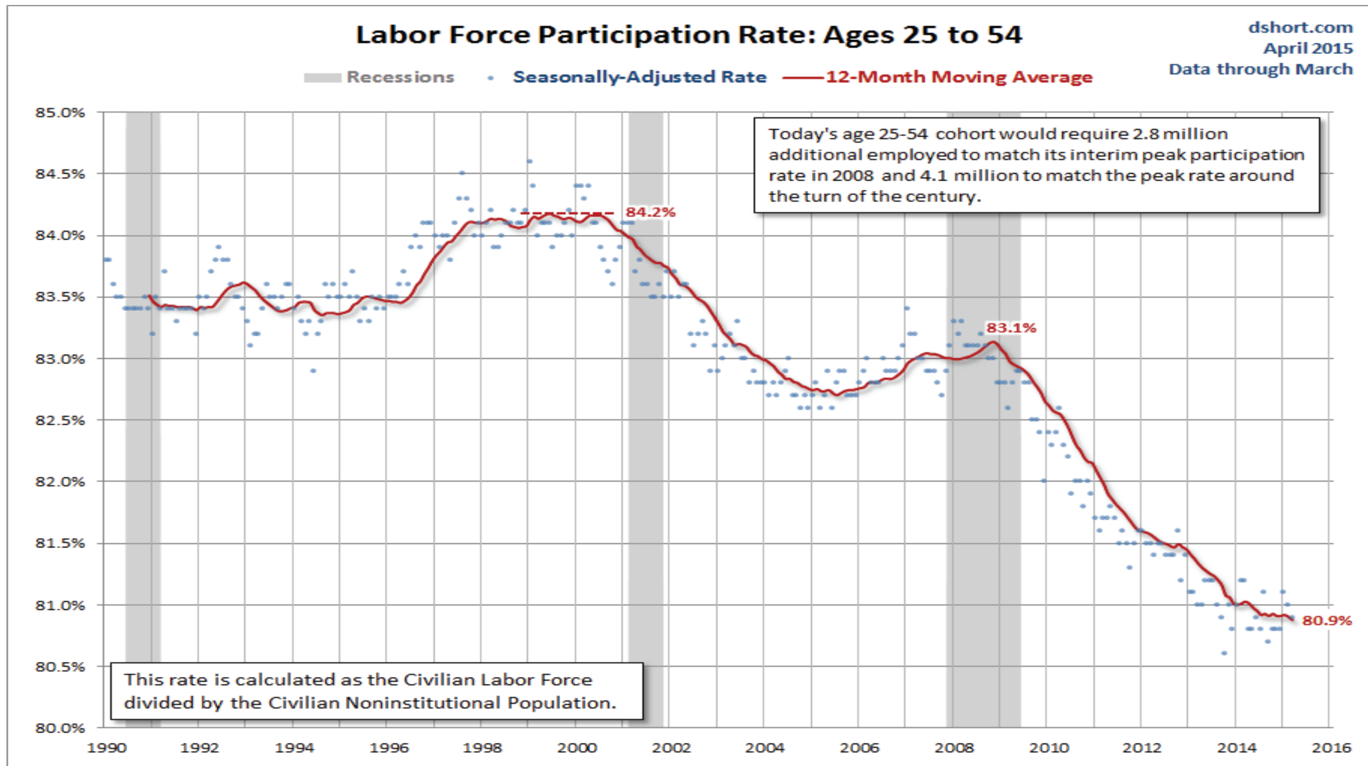
The unemployment rate (now 5.50%) has been a determinant of Federal Reserve policy throughout the years. Recently, there has been much written about the dichotomy that exists between the broad measures of economic activity (which have weakened markedly), and the unemployment rate (which has continued to fall). While it looks healthy (falling unemployment rates), it is incongruous with slower economic activity. The reason lies in the declining labor force participation rate.

For years now, RSW has addressed the less talked about labor force participation rate. While this statistic is now more widely discussed, it still seems like it is not adequately understood. Simply put, the participation rate is the percentage of the population who is over the age of 16 that is employed, or looking for work. Since the start of "The Great Recession", this rate has declined by roughly 3%, *(as discouraged workers stop their employment search)* ***and now stands at 62.70%;*** the lowest reading since 1978.

While many market participants are now talking about this topic, few have attempted to quantify the effects of a shrinking labor force participation rate on the unemployment rate. Although this exercise is above our "pay grade", a study by Goldman Sachs sheds light on this topic and serves to explain the interplay between all of the measures of unemployment. According to a recent study (Sven Jari Stehn-Goldman Sachs), the ***"real unemployment rate"*** *when considering today's labor participation rate of 62.70%, equals roughly 7 3/4%. This is an increase of 40% over the present stated rate of 5.50%.*

An interesting subset of the above is to focus on the trends in the 25 to 54 year old age group. Targeting this group eliminates the noise created by the college years, and more importantly, omits the trend in workers who are preparing for retirement. Furthermore, this should be the next generation's prime earning years where careers are built and maximum earnings are attained. As you will note from the chart below, the labor force participation of this age group has been falling steadily since 2000.

What jumps off the page to us, besides the relentless downward slope, is how much lower the rate is today than during any one of the last three recessions (shown in gray).



Show Me the Money!

Most remain surprised that our 5.50% unemployment rate has not resulted in much wage pressure. While there has been enough finger pointing to go around, it is important to note that this phenomena is not new. There is a long history of wage stagnation for most of America. Here comes the word again, but don't hold it against us...*it's structural*. The bottom 60% of wage earners have literally seen their real wages (termed household incomes after inflation) stagnate, not since The Great Recession, but for the last 50 years. During the same time period, earners just above the median (totaling 20% of employees) have seen minimal increases. In total, 80% of our households have seen virtually no increase after inflation for nearly 50 years. In fact, since the peak in 2000, real incomes have declined in a range of 8.40% to 15.90% depending on your income bracket.

Keeping the economic reality of unemployment in mind, stagnant wages serve to create a second derivative problem. The rate is merely a headcount and does not take into consideration the type of jobs that are being created. The calculation of the unemployment rate treats a part time job, a job as a waitress, bartender, or “brain surgeon” the same. So, if half the nation were doctors and lawyers, or if half the nation is working at McDonald's, the unemployment rate is the same.

Can Interest Rate Levels "Normalize"

While the market agonizes over whether the Fed will hike rates by 1/4% later this year, the Fed's final destination is what they term the "neutral rate". The Federal Reserve has often talked about an "equilibrium rate", where rates are judged to be neither restrictive nor accommodative. At present, that rate is judged by Federal Reserve Chairwoman Yellen to be 3.75%. We hope you can feel the sarcasm coming. Let's remember that for the last 5 years, U.S. GDP has averaged 2.2%, and the Fed just ratcheted down their expectations of future growth. Specifically, they believe that by 2018 growth will be stuck in the 2 to 2.30% range. So, with the same or declining growth in the next 3 years, the Fed expects us to believe that they will make 14 or 15 one quarter point increases to the federal funds rate. ***Does anyone seriously believe this is possible?***

We Simply Can't Afford Higher Rates?

Aside from everything mentioned above, we also must be mindful that much of the debt that the U.S. government issued to fund our deficit has been financed with shorter maturity bonds. With approximately one-half of the outstanding U.S. treasury bonds maturing within the next three years, the government would have to pay a higher interest rate to fund our deficit should rates rise. Currently, the average interest rate on our outstanding debt is approximately 1.23% (source: USfederalbudget.us). Based on this rate, the total annual interest expense in 2015 is projected to be $229 billion, or roughly 6% of annual government spending. If we assume that rates were to rise by just 1% to 2.23% (for entertainment purposes only), the annual interest expense should climb to $415 billion, or approximately 11% of total U.S. government spending. Akin to many countries around the globe, debt levels have mushroomed, and the higher rate on that inflated debt simply becomes unaffordable.

We Hold These Truths to be Self-Evident

While those who may think this analysis is a subtle way for us to defend RSW's asset class, we are on record that interest rates should continually surprise on the downside. With that said, more recently we felt a cautious approach was warranted. We entered the year believing that rates could experience temporary upward pressure, but that spike should be viewed as an aberration, and therefore an opportunity to extend average maturity.

As market participants, we must respect the temporary impact of “QE (Quantitative Easing) anywhere” on asset prices, but by now even Central Banks should understand its limited usefulness on the long-term impact of sustainable economic growth. This quarter much of the market's focus was on the removal of the word patient. Next quarter something will replace it. But is it out of place for RSW to ask ourselves, as investors, if removal of the word “patient” seems so relevant as the recognition that our economy, after all those surgeries, still feels like a patient?

Tax Exempt Commentary

State Tax Receipts: Uneven Performance

- *When adjusted for inflation, sales tax revenues for the 3rd quarter of 2014 were only 1% above the recessionary peak reported in the same quarter of 2008.*
- *While state and local governments have cut billions in spending, pressures persist especially in core areas such as health and education, notwithstanding the "800 pound gorilla in the room"- pension liabilities.*
- *According to a Pew foundation study there are 30 states, on an inflation adjusted basis, that are still collecting less in taxes than when the recession hit.*

U.S. retail sales, through February, declined for the third consecutive month. Lower gas prices and evidence of employment gains did little to increase consumer confidence. To some degree weather related issues in the northeast could have been a contributing factor in February but western states experienced some of the warmest winter weather on record. March retail sales increased by only a paltry 0.9% from the previous month, and only 1.3% from March 2014.

State government finances, with a few exceptions, depend on a three legged revenue stool: sales taxes, personal income taxes and corporate taxes. Sales and income taxes are by far the largest sources of state revenue. Income taxes, however, tend to be volatile as capital gains receipts are subject to market fluctuations and are less predictable for budgeting purposes. For the vast majority of states, sales tax collections provide stability and are the building block for good fiscal management.

State sales tax collections have increased by 6% during the third quarter of 2014 from the same period last year. On the surface this sounds good. However:

When adjusted for inflation, sales tax revenues for the 3rd quarter of 2014 were only 1% above the recessionary peak reported in the same quarter of 2008.

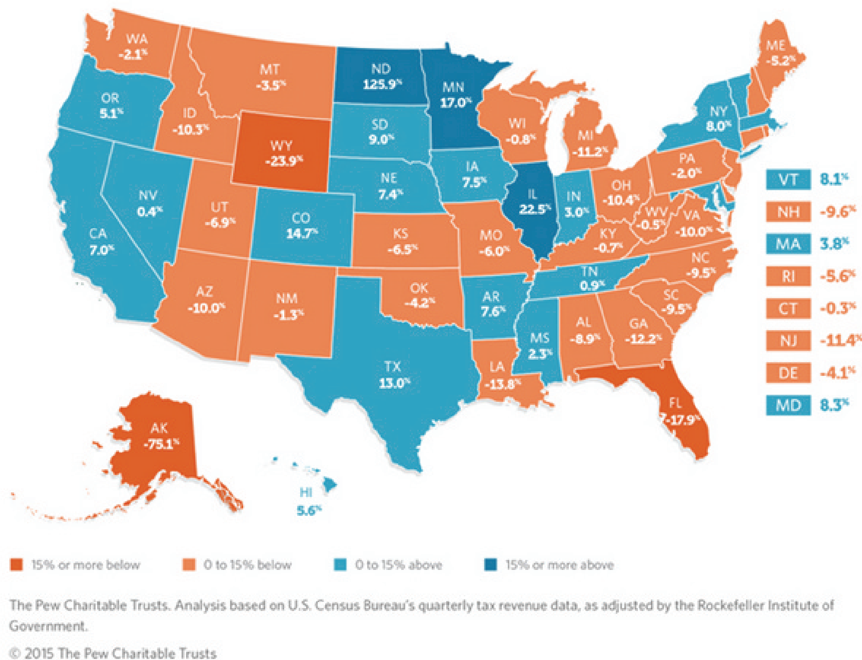
This is an alarming statistic after just over 5 years of tepid economy recovery in the aftermath of The Great Recession. While state and local governments have cut billions in spending, pressures persist especially in core areas such as health and education, notwithstanding the "800 pound gorilla in the room"- *pension liabilities.*

It Is Not Just Sales Taxes But All State Tax Revenues Are Lagging

This is why we continue to look ahead for evidence of structural budget balance and reasonable economic growth. Why is this so important? According to a Pew foundation study there are 30 states, on an inflation adjusted basis, that are still collecting less in taxes than when the recession hit. This becomes even more alarming when you consider that many states raised taxes during and after the recession. Yet, there are strong and weak performers.

Real Tax Revenue Still Lower in 30 States Since Recession

Tax collections in 3Q 2014 compared with each state's peak, adjusted for inflation



The Pew Charitable Trusts. Analysis based on U.S. Census Bureau's quarterly tax revenue data, as adjusted by the Rockefeller Institute of Government.

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A Few Important Examples

Florida (Aa1/AAA/AAA) *(statistics can be misleading)*

According to the above chart, Florida (with the exception of smaller Alaska and Wyoming both mineral extraction states) has suffered the largest inflation adjusted decline (18%) from the peak before the recession. This would, on the surface, appear to show that the economy and credit of the state remains depressed. This is anything but the truth. In fact, the state's sales tax collections (there is no income tax) have increased by roughly 24.5% or $4.2 billion from the nadir in fiscal year 2010. The "Sunshine State" has kept its high grade ratings throughout the breadth and depth of The Great Recession.

What the above chart is reflecting is the boom and bust cycle of the speculative housing market of the state. In short, the 2006 and 2007 sales and documentary real estate stamp surge in tax revenues reflected the "boom cycle" of the juiced up economy. This is the base for the 18% revenue decline.

While the real estate market is showing signs of recovery, the significant increase in sales tax receipts and the state's strong fiscal management continue to support "AAA"ratings.

Texas (Aaa/AAA/AAA) *(built to stay that way)*

Only Minnesota and Illinois, as large states, showed higher inflation adjusted increases in tax revenues from the pre-recession peak than Texas. However both states, unlike Texas, implemented significant tax increases during this period. There is no question that the Texas economy has by far out-stripped the nation's economic growth rates in the aftermath of the recession. Despite year-over-year declines in tax receipts in fiscal years 2009 and 2010 of approximately 9% and 5% respectively, tax revenues have increased dramatically from $35.8 billion in fiscal 2010 to $51.4 billion in fiscal 2014- an extraordinary 44% increase in a 4 year period. The state reported that February 2015 sales tax revenues were approximately 12% higher when compared to the same month in 2014. Texas, similar to Florida, does not have a state income tax.

The decline in oil prices will slow the state's surging economic growth; however the Lone Star State will still outperform national growth rates and maintain "AAA"ratings.

New Jersey (A2/A/AA-) *(negative outlook)*

Of the larger and wealthier states, New Jersey has experienced one of the worst declines in inflation adjusted tax revenues from the pre-recession peak as indicated by the chart. In real terms fiscal year 2013 sales tax collections (audited 2014 numbers not available) of $8.4 billion have improved by roughly $500 million from fiscal year 2010, *however they still remain $500 million below the pre-recession peak of fiscal 2008.* The same trend is evident in income tax collections whereas fiscal year 2013 receipts of $12.1 billion were roughly $1.5 billion more than fiscal 2010, they also remain $500 million below 2008 levels.

The relative lack of economic growth, coupled with long term pressures from unfunded health and pension benefits, puts the credit under short and long term duress. It is for this reason that we keep client exposures relatively short in duration.

Summary and Conclusion

- For the quarter, the yield curve steepened as rates declined on shorter maturity bonds, while rising on longer (12 years +) maturity securities.
- Interest rates fluctuated sharply movements during the first two months of the year, but in opposite directions.
- Ten-year "AAA" rated yields declined 32 basis points during January, then reversed course, rising by 30 basis points in February.
- While interest rates vacillated during the quarter, the movements were uneven depending on the final maturity date. For example, bonds maturing in 15 years rose by 12 basis points, while 5 year maturity tax-exempt bond yields fell by 9 basis points.

An uneven economic recovery has produced winners and relative losers. Five to six years after The Great Recession, while municipal credits have, on average, stabilized, issues persist. At RSW it is our responsibility to minimize exposure while maximizing returns consistent with capital preservation.

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