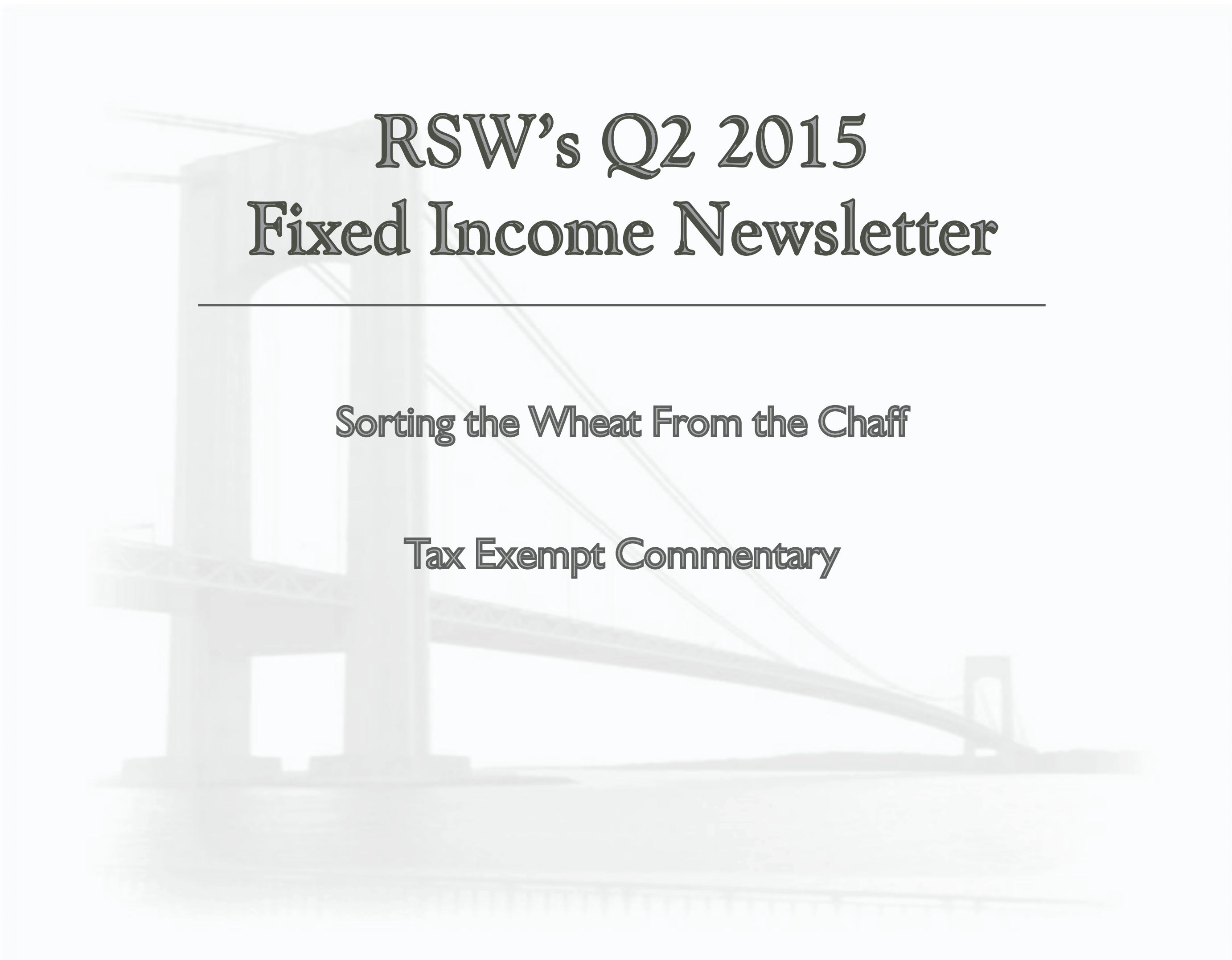
July 16th, 2015



RSW's Q2 2015
Fixed Income Newsletter

Sorting the Wheat From the Chaff

Tax Exempt Commentary

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

Sorting the Wheat From the Chaff (7/16/15)

At RSW we have never cowered from sharing unsettling, or unpopular news. We have, and always will "call them as we see them".

As Greece grabs all of the headlines as of late, and interest rates lurched upward toward the "zone" (2.60% to 3.00%) that RSW wrote about in our 2015 outlook, another story is developing.

As deflation advances steadily and globally, obligations of all "stripes" are being denigrated. China, Greece, and Puerto Rico are just some examples. There is simply too much debt relative to the income needed to service it.

Why Should You Care?

Historically, some of the best and most enduring values in the municipal market have been state general obligation bonds. Massachusetts was downgraded to minimal investment grade ("BBB" by S&P) in November 1989. Similarly, California was downgraded to "BBB" in July 2003. After various incremental upgrades, both states are currently rated "AA+" and "AA-" respectively.

The low point in the creditworthiness of their debt was more of a reflection of the weak economic cycle than embedded structural imbalances. This is no longer true today as the erosion in credit quality reflects structural budget imbalances largely attributed to growing pension liabilities that do not lend themselves to fiscal or politically feasible solutions. For some states and municipalities, we see little hope for improvement and only lower prices with no identifiable floor.

Back in 2010, Meredith Whitney, an analyst with no public or municipal finance background , misspoke on "60 Minutes" when she predicted "hundreds of billions of dollars" of municipal bond defaults were forthcoming. Despite subsequent backpedaling, the damage was done as many individual investors sold positions causing yields to spike. More importantly, this faux pas also resulted in a wide open "window of opportunity" for investors to swoop up good quality bonds at lower and more attractive prices.

Also in the same year, another investor, Warren Buffet, with a lot less fanfare and publicity, stated that ballooning pension-benefit liabilities will become a massive issue in "five or ten years from now". We concurred. State and local governmental pensions have been a recurring theme of this publication for five years running.

Well now the five years have passed and here we stand:

- Notwithstanding the bankruptcy of Detroit, the multiple downgrades of Puerto Rico to junk status, the criminal indictments of various participants in the Jefferson County, and Alabama sewer debacle, the general status of the municipal market remains strong with average credit ratings in the "AA" category.

- This remains true in the aftermath of the Great Recession despite the weak recovery with many jurisdictions still seeing annual revenue collections below pre-recession peak levels when adjusted for inflation and others, even worse, still lagging on a dollar for dollar basis.

- In short, Meredith Whitney has faded into history.

- Unfunded pension liabilities are the bane of the municipal market.

- Unlike Whitney's prior "window of opportunity", the unfunded liabilities of many weak credits do not represent a "buying opportunity on weakness" *as we cannot foresee, where the "floor" for bond prices and valuations will ultimately be for those issuers afflicted with significant unfunded pension costs. These credit spreads should continue to widen corrective measures remain fleeting.*

- For many issuers, notably the states of New Jersey and Illinois and city of Chicago, recent state court rulings have either complicated or disavowed legislation enacted to address pension liabilities. Alternative solutions are not easily identifiable and not without fiscal duress.

Things to Consider:

Rating Agency Cherry Picking: Case in Point, Chicago

- In the last two years Moody's downgraded the City of Chicago seven notches to junk bond levels (May 2015). Not surprisingly, the city did not seek a Moody's rating for their last four sales. Instead, they sought and received an "A-" rating from Kroll. Both Fitch and Standard & Poor's still assign investment grade ratings.

- As reported by the *Wall Street Journal* (6/18/15), Moody's analysts asked city officials "Help me understand why Chicago is different than Puerto Rico?" The article also reports that Chicago debt and pension payments as a percentage of revenue is an alarming 45%. The city's unfunded pension liabilities total approximately $19 billion.

Illinois

- On May 8th 2015, the Illinois Supreme Court upheld a lower court decision that found the recently passed state pension reforms to be unconstitutional.

- Accordingly, the state's unfunded pension liabilities of $111 billion lack any viable plan to reduce and to provide for this massive liability. The state is hard pressed to enact a budget for the fiscal year that began July 1st that will be remotely structurally balanced.

- We suspect that the state's "A-"credit rating, the lowest state rating in the nation, will soon be subject to further downgrade.

- The bonds currently trade at below investment grade levels.

New Jersey

- The governor's budget plan for fiscal 2016 reneges on a statute that he had signed into law that mandated specific and growing levels of revenues to the pension fund. The state supreme court upheld the governor's right to do so. While this provides some short term relief, it only adds to the current unfunded liabilities.

- Democrats in the state legislature are proposing increases on income taxes on the wealthiest taxpayers and on corporate taxes in order to compensate. Needless to say, timely budget adoption was not forthcoming.

- Tax increases in a state that is already a high tax state with one of the nation's worst economic performances can only exacerbate growth prospects.

Connecticut

- Similar to New Jersey, the state's economy is one of the worst in the nation. The adopted budget included $2 billion of tax increases on corporations and high net worth payers. Many of the state's largest and most important employers have notified the state of their intention to consider relocation, especially as a portion of the proposed increase was retroactive. The governor subsequently rescinded some of these taxes.

- Unlike New Jersey and Illinois, the state is fully funding its actuarially calculated annual pension obligations. However, its unfunded liabilities remain as one of the worst in the nation.

Pennsylvania

- While the state is not experiencing the severe credit and fiscal weakness of the three aforementioned states, deterioration is evident and its yield levels are increasing relative to stronger states.

- Anticipated increases in annual pension costs, the need to replenish depleted reserves, and dependency on one shot non-recurring revenues are critical factors that will require hard decisions and potentially crowd out essential services.

	Pension Funded Ratio	UAAL[1] ($B)	UAAL % Change[2]	UAAL Per Capita ($)	Standard & Poor's Ratings
Connecticut	49%	25.2	60%	7,011	AA / Outlook Negative
Illinois	39%	100.5	61%	7,802	A- /Watch negative
New Jersey	63%	50.7	46%	5,698	A /Stable
Pennsylvania	62%	50.5	137%	3,953	AA- / Stable
Puerto Rico	7%	33.7	1.80%	9,251	CCC+ / Watch negative
All States Average	**71%**	**18.5**		**3,231**	

[1] Unfunded Accrued Actuarial Liabilities
[2] 2010 to 2013
Source: Standard & Poor's

Real Gross State Product

	2013-2014 % Change	2004-2014 % Change (Ann.)
All States Average	**2.2**	**1.4**
Connecticut	0.6	0.3
Illinois	1.2	0.6
Pennsylvania	1.8	1.0
Texas	5.2	3.5
California	2.8	1.5
New Jersey	0.4	0.4

Source U.S. Bureau of Economic Analysis

Summary and Conclusion

- As the above charts demonstrate, these states have some of the worst funded pensions in the nation with the highest unfunded liabilities. At the same time, their economic growth rates over a ten-year period and on the most recent year-over-year basis are also amongst the lowest in the nation. The weak economic growth suggests that these states cannot count on "growing revenues" to alleviate fiscal pressures. Tax increases on the existing base should not be considered a panacea, as the Connecticut corporate response to the proposed tax increases demonstrates.

- We fully anticipate the possibility of downgrades over the near term for Connecticut, Illinois, and New Jersey as fiscal year 2016 unfolds. Over the longer term, without corrective actions, we could actually envision Illinois and New Jersey flirting with below investment grade ratings.

- Years ago, for "State Preference" or "State Specific" mandates we strategically shortened the average maturity and/or durations on RSW client holdings of New Jersey, Pennsylvania, and Connecticut state bonds. We do not and have not invested in State of Illinois or Puerto Rico paper on behalf of our clients.

- As we have said in the past, "This is not your grandfather's municipal bond market". Therefore, our credit decisions will continue to reflect the evolving headwinds faced by a number of municipal issuers.

- We have discussed a few select issuers, but the problem is virtually certain to expand to other jurisdictions.

- Since the inception of RSW Investments, we have constructed portfolios anticipating a growing unfunded pension liability problem.

- The history of structural issues such as this tells us two things. First, there will be more negative news than positive. Secondly, there should be future dislocations whereby the "baby gets thrown out with the bath water."

- To put this in terms that are more commonly encountered, we will use an analogy from the equity market. When a previous technology darling, Blackberry imploded, no one immediately panicked and sold Apple.

- We will neither be shy about discussing the depth and breadth of the problem nor shy away from viewing it as an opportunity if managed correctly. We can already visualize the front page of the *Wall Street Journal*, the *New York Times* and *Fortune* magazine screaming about unfunded pensions while we are recommending that our clients add funds to their existing accounts.

- The problem will unfold unevenly and on a continuum with borrowers such as Puerto Rico & Illinois on one end, and Florida & Texas on the other. Winning investors in this process will successfully avoid the next crop of issuers that are more like Puerto Rico & Illinois.

Robert S. Waas **Managing Member**	**Stephen R. O'Donnell** **Senior Portfolio Manager**	**Robert K. Coates** **Senior Portfolio Manager**	**Mark J. Tenenhaus** **Director of Municipal Research**	**Matthew T. Werner** **Portfolio Manager**	**Marites V. Pasturan** **Data Analyst**	**Randy J. Fox** **Operations Associate**	**David Lim** **Client Service Associate**