RSW INVESTMENTS

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We Didn't Start the Fire

Municipal Bond Prices Catch Fire

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We Didn't Start the Fire (1/20/15)

History shows that what starts as an overall lack of fear, becomes outright complacency, which inevitably leads to the "Minsky Moment" of instability.

Virtually every major Central Bank has outright expressed, or at the very least implied to market participants that not only do they have "our backs", but our backsides too!

If distorted markets create distorted behavior, we can logically infer that unprecedented excesses exist somewhere in the system and probably in many places.

The entire financial system has been re-stocked with dry kindling and oil is the most likely match.

Today, the hot debate centers on whether plunging oil prices are a *boost to* or *detractor from,* economic growth. One view is that declining oil prices enhances consumer spending power, as fewer dollars spent at the pump allows more to be spent on discretionary items. The counter argument is that a collapse in price causes both a reduction in energy related investment (CAPEX), and a loss of high paying jobs which combine to offset the simulative effects of lower crude prices. There is little doubt of the truth in both arguments, but it's probably not too early to declare which carries the most weight. In the final analysis however, the answer to the following two questions is more important.

- *Is oil the latest victim to be claimed by deflation, and is its decline forecasting a world economic slowdown or worse?*
- *Does the speed and scope of the collapse create systemic risk?*

We will address such questions more directly later.

We begin by describing what we believe to be the economic/financial environment in which oil's unexpected plunge occurred. Much like Einstein's "Theory of Everything" that seeks to explain comprehensively how the universe functions, today's economic predicament may be explained by the Hyman Minsky's (economist) "Financial Instability Hypothesis". Its "unifying" feature is that it not only deals with economics and markets, but with its corresponding human behavior. Oversimplified, it states that "stability is destabilizing". More fully explained, it describes that periods of stability create behavioral responses that erode margins of safety, reduce liquidity, increase debt relative to income and profits, and raises the price of risky assets relative to safe assets. All of these combine to weaken the ability of the economy to withstand even modest adverse shocks.

History shows that what starts as an overall lack of fear, becomes outright complacency, inevitably leads to the "Minsky Moment" of instability. Think about human nature. Even If a person feels that they will be partially indemnified from substantial loss or personal harm in any pursuit, their risk tolerance increases. We at RSW, would further make the point that this principle appears to be the unifying force between every major Central Bank in the world as they attempt to:

- Create and maintain historically unsustainable levels of volatility.
- Lower interest rates to drive market participants into riskier asset classes.
- Coax investors to accept lower levels of liquidity.
- "Force" investors out on the yield curve (buy longer maturity debt) to enhance their income.

Let's take the theory and apply it to both today, and that period leading up to the housing crisis. With the benefit of hindsight most would concede that Alan Greenspan, by keeping the Fed Funds rate at 1% for too long, contributed to the housing boom. This created an atmosphere of the "Fed has our backs" that made extreme speculation and leverage not seem so extreme. Liquidity wasn't an issue, debt versus cash flow wasn't a concern, adjustable rate loans were “OK” because rates would always stay low, and housing will never exhibit a meaningful nationwide decline. Against this backdrop, packaged loans and "structured debt" became all the rage. In summary, the Fed didn't light the match but they did supply the dry kindling to assist in creating an impressive blaze.

Fast forward to today. Virtually every major Central Bank has outright expressed, or at the very least implied to market participants that not only do they have "our backs", but our backsides too! Today is it fair to say that Hyman Minsky's Instability hypothesis is now on steroids and injected globally? What the world's Central Banks have done collectively in the last 5 or 6 years makes what Alan Greenspan did look like a tightening. The world's risk appetite has dramatically increased. Additionally, they have accepted weakened covenants (fewer promises to lenders as specified in the bond documents) without blinking, and all of this has been done with a sense that Central Banks won't let anything bad happen.

To continue our analogy the entire financial system has been re-stocked with dry kindling and oil is the most likely match. While almost no one believes that this match burns as hot as subprime mortgages, remember Minsky's hypothesis:

All of the excesses combine to weaken the ability of the economy to withstand even modest adverse shocks.

This period in worldwide financial history is unprecedented. If distorted markets create distorted behavior, we can logically infer that unprecedented excesses exist somewhere in the system, and probably in many places. The match may not burn as hot, but with the pile of kindling being higher and drier it is undoubtedly easier to ignite. Could oil be the asset class that trips us into meaningfully slower economic activity and upsets the "risk markets"?

So, Are Plunging Oil Prices a Boost or a Detriment to Economic Activity?

It's now time to vote. While there is still time to allow events to unfold, we admit to a bias that the plunge in oil prices is a net negative to our economic health. We arrive at that decision using the same logic as the majority of mainstream economists. For years, we have read and seen economic reports that contended that the "shale revolution" would add 100 to 150 percentage points to GDP. It was the "American Renaissance" and an "American success story". It was told that even though the cost of extracting oil and gas was relatively expensive, the increased capital investment (CAPEX), the creation of many high paying jobs, and the resulting increase in consumer spending would rule the day over higher cost. If the initial forecasts were accurate, the reversal of those two forces, should cause a noticeable weakening in GDP.

For those of us charged with managing money, whether GDP slows or speeds is important but not an earth shattering consideration. However, the two questions posed at the beginning of this musing are the ones that have significant consequences if answered incorrectly. Shown again they are:

- *Is oil the latest victim to be claimed by deflation, and is its decline forecasting a world economic slowdown or worse?*
- *Does the speed and scope of the collapse create systemic risk?*

While we have already addressed the first question and have a strong opinion, our conviction level for the second one is weaker. Minsky (long periods of stability may serve to mask stealth instabilities) would have felt at home with the following economic/market events:

- Shale boom created a surge in energy related borrowing that now represents around 18% of the high yield bond market.
- Wall Street and community banks are huge lenders to this sector, tied to oil revenues.
- As revenues contract the ability of borrowers to repay principal and interest is diminished.
- There have already been a small number of bankruptcies, does it increase?
- There are serious dislocations in the currency markets exacerbated by oil. Does this worsen?

Yes, the environment described herein breeds systemic risk, but recent events also demand a certain amount of humility. If we didn't see oil's sudden collapse to $45 from $106, we shouldn't feel very confident of the next $10 move, or what effect it can have on economies or financial systems. What can be said, with a higher level of confidence, and with a sense of historical fact about human response is that somewhere in the financial system there exists outsized risk and diminished risk controls. As you may recall the last time we began commenting about a hazard such as this, was in RSW's Q1 2007 commentary where we said: "It is no longer out of place to fear both a financial event where securities and institutions of all kinds are affected, and an economic contraction caused by a severely damaged consumer".

One final note of caution in this era of Central Bank omnipotence is warranted. From RSW's perspective, all too often investors misinterpret the message of the Fed, or any Central Bank. All these "bankers" can do is whisper into your ear that they will not be the proximate cause of increased volatility. They will also promise not to be the cause of economic and financial disruptions. Lastly, they will insist that a collapse in the price of oil is not their doing. But that doesn't mean that they can prevent it from happening, or stop it when it starts, or control the unintended consequences that result. None of this means however, that they didn't provide all of the ingredients to ensure that the flame burns hot. Rest assured, and have no doubt, that if some major dislocation befalls the financial system, the Fed and all of their Central Bank brethren, in their best Billy Joel voice will all claim: *"We Didn't Start the Fire".*

Municipal Bond Prices Catch Fire

The bond markets did not necessarily move in accordance with the "fundamental economic backdrop" as yields skidded lower despite December's third quarter GDP revision to 5%. This was the highest quarterly growth rate in more than 10 years. Instead, despite the strong economic growth, the bond markets continued to rally with ten-year Treasury yields getting back toward the low levels of the year. Municipal bonds followed accordingly. Falling oil prices, deflationary concerns, slower growth in China and fears of recession in Europe overwhelmed any consideration that may have been given to the GDP report.

Nevertheless, economic growth remains "uneven" at best with employment levels in many states still below pre-recession levels. "Top line revenue growth" in most states is tempered, as many jurisdictions remain burdened by rising long-term expenditures (mostly Medicaid, health care and pension liabilities). Accordingly, our pencil remains sharp with respect to those issuers that are not fully participating in the economic recovery and/or are far from resolving long standing budgetary imbalances.

To this end we see little, if any, positive prospects for **Illinois** and **Puerto Rico**. The newly elected Republican governor of Illinois will be challenged to present a budget that will be hampered by the sunset of the temporary income tax hike this year in addition to a lower state court ruling that overturned previously enacted pension reform. The state supreme court is expected to hear arguments in the near term. **Pennsylvania** and **New Jersey** still exhibit growing pension liabilities with little momentum for corrective action in addition to revenue declines and/or overly optimistic projections. The states exhibiting the most positive revenue growth are in the **West** and also **Texas** and **Florida**.

What About the Rapid Decline in Oil Prices?

At the least, consumers will benefit. Sales taxes, the largest component of most state revenues, will also increase as retail sales strengthen. What is less obvious is the lack of a relatively immediate negative impact on the oil producing states as prices have rapidly plummeted. Most state fiscal years start on July 1, therefore budget formation and revenue forecasting are currently being formulated. This will give those states some room to adapt to the rapid changes to date. Most oil producing states, with a full understanding of the boom and bust cycle of the industry, have accumulated and maintained sizable reserves in the event of such an occurrence and have various constitutional spending restraints.

Alaska is by far the most oil dependent state, and is experiencing just over a 50% shortfall ($3.4 billion) in their current budget. The state does however, hold roughly $15 billion in various reserves (with derived annual income in excess of $1 billion). This is in addition to the $51 billion dollar Alaska Permanent Fund with earnings in excess of $4 billion. While all rating agencies have affirmed the state's AAA rating, Moody's has changed the outlook to negative implying that a downgrade could be possible in approximately 2 years.

Unlike many states, employment levels in **Texas, Oklahoma and Louisiana** have surpassed their pre-recession levels. While various local credits in these states could see downgrades as a consequence of lower oil prices, we take a more stable view of the respective state obligations. As the GDP in the state of Texas reflects just less than a 20% exposure to oil and gas extraction, its diversified and large economy should, in the aggregate, benefit from lower oil prices. Accordingly, oil and mineral related revenue support a relatively minimal 4.8% of the state's budget. 75% of all oil and gas production tax revenues in excess of 1987 levels are mandated by the state constitution to go to stabilization and highway funds and not the general fund.

In Oklahoma, only 4% of such taxes go to the general fund to support general spending. The state constitution also allows for only 95% of certified revenues to be budgeted and for automatic across the board expenditure reductions in the event of shortfalls.

In Louisiana, oil and gas related taxes are roughly 13% of revenues. To wit, the state has to date implemented expenditure reductions and has drawn down on various reserves. Sustained declines in oil prices could ultimately increase credit pressures in Oklahoma and Louisiana.

Summary and Conclusion

As history has demonstrated, the bond markets tend to be the "real" harbinger of things to come. A string of relatively good GDP reports cannot do enough to counter deflationary fears and global economic weakness, both reflected in lower oil prices.

Accordingly, a low interest rate environment coupled with narrow credit quality spreads, uneven regional economic prospects and massive unfunded pension liabilities, dictate that we at RSW maintain a heightened level of investment discipline.

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