April 9th, 2018

RSW's Q1 2018 Fixed Income Newsletter

An Interest Rate GPS

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Your Rate Guidance Starts Now

During the first quarter, 10-year U.S. Treasury bond yields traveled to 2.95% (slightly exceeding RSW's target of 2.90%). What brought us to that level of rates? To start, the Federal Reserve believes that there is enough economic momentum to justify a reversal of their low interest rate policy borne from the financial crisis. At its core, the Fed has joined the "synchronized world growth chorus" and are therefore striving to "normalize rates". The Fed's "navigation system" assumes an unemployment rate at or near full employment, with a hint of improving wages. Specifically, the policy makers are concerned that tightness in the labor market could cause the Core CPI (CPI less food and energy) rate to exceed their target level of 2%.

Many traders and investors were also worried about the swelling of the federal budget deficit arising from both the passage of tax reform and the recent approval of the bloated omnibus budget package. The deficit expands the government's need to borrow monies (Treasury bond issuance) and it comes at a time when the Federal Reserve is allowing their balance sheet to shrink by incrementally reversing their long standing Quantitative Easing (QE) policies. As the Fed's fixed income holdings (currently on their balance sheet) receive a coupon payment or bonds mature, the Fed is reinvesting a lesser amount of the proceeds to acquire more U.S. Treasury bonds. The combination of an increase in supply (deficits) combined with lower levels of demand (Fed) has served to push rates higher.

In a Quarter Mile Make a U-Turn

Why did rates stop where they did, at least for now, and why do we believe rates could stabilize and even have some room to decline? From a technical perspective, there is deep support around 2.90% on 10-year U.S. Treasury bond yields. That is, if one were to connect the long-term peak in yields going back 25 years, it would become apparent that the bond market reached an important inflection point. Furthermore, many market participants who were concerned about higher interest rates, already sold or shortened the average duration (measure of interest rate sensitivity) of their portfolios. Quite often, when a market runs out of sellers, it doesn't take much good news to propel prices higher (yields lower). Lastly, many traders are talking about a yield target of 3%, our belief is that we will likely not reach this destination on the first try.

From a more fundamental perspective, there are reasons for longer-maturity yields to have leveled-off as the economy seems to be losing momentum. The drumbeat of "synchronized world growth" has been somewhat lessened by several mixed economic releases both here and abroad. For example, many economists entered the year believing that first quarter 2018 GDP could reach 4%. For all intents and purposes, the average estimate has now been cut in half to around 2%. Furthermore, the introduction of the chance of full scale "trade wars" (RSW believes these fears to be overblown) has no good outcome. As we have witnessed, even a skirmish can hurt any market that is not "priced" for negative events. In the case of bonds, prices can be driven higher (yields lower) as growth forecasts are sliced.

Another dynamic that is so basic it tends to be overlooked, is that the surest path to lower rates is for them to first push higher. From the lows, U.S. Treasury bond yields are up 100 to 150 basis points (1-1.50%) depending on maturity. Higher rates and the related climb in interest expense must already be exerting financial stresses on individual, government and corporate balance sheets. The increased interest expense is clear as evidenced by steadily rising LIBOR (London Inter-Bank Offered Rate). Specifically, 3-month LIBOR hit its highest level in over 9 years and acts as the reference rate for trillions in derivatives and loans, including mortgages. Taken as a whole, it seems reasonable for markets to pause and assess the dampening effects of these increases as they work their way through the system. Risk markets (i.e. equities, corporate high yield bonds) may be confirming that suspicion.

Your Destination is One Mile Ahead on The?

We peer into the future and ask where rates are going from here and what might get us there. At RSW, we believe that market yields already echo many investor concerns. Specifically, today's elevated rates appear to reflect an opinion that the Fed will hike rates every quarter for the next year and a half. They also assume a rate of growth closer to 3% than the recent 2%. Additionally, the spike in Treasury bond issuance (due to trillion-dollar budget deficits) is being priced into rates as the new normal. Currently, it appears that elevated longer-term bond yields seem to support a belief that a durable economic expansion will be extended by the stimulative effects of tax reform.

The risks to our steady/declining yield forecast include: sustainable 3% GDP growth, a spike in the general level of inflation, higher than expected wage inflation, full blown trade war and a continued decline in the unemployment rate. In a world where nothing happens in a vacuum, a change in European Central Bank (ECB) or Bank of Japan (BOJ) bond buying would also impact rates around the world. Any one of these factors or some combination could certainly disturb the bond market.

What Does This Mean for Our Clients Invested in Municipal Bonds?

For the quarter, on the back of rising rates in the U.S. Treasury bond market, "AAA" rated tax-exempt bond yields (market proxy) were lifted from 13 to 45 basis points depending on the maturity date. Despite RSW's more optimistic tone and outlook, the interest rate sensitivity (duration) of our client portfolios, irrespective of their stated strategy, remains tilted toward a below average level of duration. This is borne from a respect for the risks highlighted above, the yield differential between tax-exempt bonds and comparable maturity U.S. Treasury securities, and the seasonal nature of the returns typically generated in the municipal bond market.

As we entered the year, we began in a period known as the "January effect". Mid-December through January has traditionally marked a time when tax-exempt prices rally (yields decline) as the level of new issuance shrinks and investors are busily reinvesting cash flows. Outsized amounts of bond calls, maturing securities and coupon payments are put back into investors hands during the early part of the quarter and again in the middle of the year. Historically, we have seized the opportunity to extend the interest rate sensitivity of our portfolios to generate enhanced price appreciation during these periods.

This time however, we believed that the reward of shifting to an average or above average duration was not warranted given overall market risks. Ten-year "AAA" rated municipal bonds were only yielding approximately 82% of 10-year US Treasury bonds (1.98% Muni vs 2.41% Treasury) further giving us pause. While this ratio could be considered fair value, our patience was rewarded, as a spike in demand for tax-frees failed to emerge. The result was a municipal bond market that turned in one of the weakest first quarter performances recorded since 1996.

Currently, the tax-exempt market is beginning to look more interesting from our perspective, as the "10-year ratio" has climbed to 87%. With that said, we will continue to take a wait and see approach, but are closer to taking action on locking-in these higher rates and ratios than where we were at the beginning of the year. As always, we look forward to continuing to keep you apprised of our portfolio positioning and market developments.

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