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RSW's Q1 2019 Fixed Income Newsletter

"Don't Stop Believin"

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"Don't Stop Believin"

"Patiently"

Last year, we leaned against the chorus of prognosticators and market participants who believed that the *Journey* toward ever increasing interest rates would continue unabated. Specifically, it was perceived by the crowd that the Fed would continue to hike rates persistently into 2020 and that yields on longer-maturity bonds would likewise continue their ascent. At that time, we were also dismissive of such news headlines as:

- "We Ran Out of Words to Describe How Good the Jobs Numbers Are"
- "The US Economy Suddenly Looks Like it's Unstoppable"
- "Economic Growth in U.S. Leaves World Behind"

Instead, in RSW's Q2 2018 missive we reiterated our position that "the current pace of faster economic activity was not sustainable. The interest payments on the bloated levels of debt should act as a formidable force against long-term 'trend type growth.'" Furthermore, we held the view that the Federal Reserve had already over-tightened and that economic growth would soon stall. In fact, roughly one month later on 5/16/18 in a brief commentary titled "The Time is Now" we said "with 10-year U.S. Treasury bond yields at 3.10% we are ready to release RSW's third strong buy recommendation in 13 years."

Now, the upbeat headlines shown above are being replaced with articles about how:

- Atlanta Fed's estimate for GDP, crumbled to 0.2% from last month's estimate of 2%.
- The percentage of sub-prime borrowers that are more than 90 days late is now at the highest levels since the Great Recession began.
- "U.S. CFOs Overwhelmingly Expect a Recession Within Two Years"

Against a back-drop of increasing economic pessimism and falling levels of inflation, at a January 30th press conference the Federal Open Market Committee (FOMC) pledged to be *"patient"* on the timing of future rate adjustments. Furthermore, they commented that they would be flexible in shrinking their holdings of U.S. Treasury and mortgage-backed securities, depending on economic conditions.

Amidst a global economic contraction the FOMC, led by Chairman Powell, seems to share our view. On March 20th, he signaled that all future rate hikes planned for this year have been shelved. Shortly after making that statement, 10-year U.S. Treasury bond yields fell by 20 basis points to 2.41% which was below the three month U.S. Treasury Bill yield of 2.45%. This phenomena, where long rates are lower than short term rates is known as an "inverted yield curve". Market participants pay close attention to this event as it has long been a reliable indicator for signaling a recession (inverted yield curve), on average within 14 months from the date of inversion.

"Any Way You Want It"

As of late, it's hard to read any economic news these days and not learn about a debate that is raging about Modern Monetary Theory (MMT). Wow! That sounds so boring, who are the people who actually debate this stuff? …stay with us…there is a point to be made!

At its core, proponents of MMT argue that countries who issue bonds in their own currencies do not need to worry about how much the government spends because they can conjure-up unlimited amounts of money to pay off their debt. This means that constraints on government deficit spending are an illusion as a sovereign issuer of fiat currency can never become insolvent.

Furthermore, these advocates believe that a flood of money and increased spending isn't likely to generate a surge in the rate of inflation, well, simply because it hasn't happened yet. In short, for MMTers, the government determines the appropriate amount of money necessary in the financial system to ensure high productivity, a low unemployment rate, and a well-behaved inflation rate. This is in stark contrast to the traditional view which rests on the banking system to make loans and the central bank to set interest rate policy.

Recently, prominent economists including Chairman of the Federal Reserve Jerome Powell and European Central Bank chief economist Peter Praet have weighed in on the merits of the theory. Chairman Powell recently called the concept "just wrong." Powell believes that the trajectory of the government's debt levels are unsustainable and increasing at a speed that is greater than the pace of GDP. Praet said "the general idea that government debt can be financed by central banks is a dangerous proposition".

Sparing you from further quotes, let's just say that most prominent figures believe that the theory is "voodoo economics" while some such as Paul McCulley (former co-head of PIMCO) believe that the tactic offers a strategy that is worthy of consideration and affords a "robust architecture for a fiat currency world".

OK, time to make a point. Do you think that the MMT debate centered on an *"any way you want it"* type of financial engineering is front and center because the health of the global economy is sound? Or is it because despite 10 years having passed since the Great Recession, across the globe, we remain in the grip of a deflationary quagmire? You won't need a Doppler Radar or Satellite Data to track what's headed for our shores. Later this year, we believe this storm should emerge in plain view and show itself in the form of a massive deleveraging cycle. This cycle typically occurs as the limits of debt growth relative to income growth are reached and the process of prosperity creation gets thrown into reverse.

"After the Fall"

If you are looking for concrete evidence that globally we are in a deflationary, not inflationary cycle, look no further than the phenomena of negative interest rates. Today, longer-maturity bonds carrying negative yields have mushroomed and now total more than $11 trillion. When investors are willing to pay governments for the right to lend them money something may be askew with the health of their economies. If the debt markets were functioning properly, these instruments that confiscate wealth wouldn't exist.

In this low interest rate world, when periods of economic contraction emerge, the hands of the central bankers are essentially tied. Rate cuts could become a scarce antidote, as they would be initiated from levels that have already "*fallen*" close to, or below zero percent. To that end, we have always believed that the motivation behind the Fed rate increases was their desire to drive rates high enough so that they could adequately respond to an economy that may slow to stall speed. After eight rate hikes today's Federal Funds Overnight Target Rate sits at only 2.40%. To put this paltry yield into perspective, historically the Fed has slashed rates by 400-500 basis points to lift the economy out of a recession. Therefore, the Fed may only be left with a rate cut response that is one-half of what's actually needed.

In this world of low interest rates, we should expect "unconventional" responses to recessions. The MMT financial paradigm may be just one of them as the world's Central Bankers *"Don't Stop Believin"* that they have the tools necessary to create a "no pain gain" cure to end global deflation.

What does this mean to fixed income investors? The bond market is already well on its way to pricing-in a massive deleveraging cycle that is headed in our direction. With that said, as debates rage about unconventional solutions and possibly even their implemention, it is likely that this should result in an increased level of long term bond yield fluctuations. However, against our forecasted weaker economic backdrop, we would once again view a surge in rates as an opportunity to enhance the interest rate sensitivity and yield of our client portfolios (where appropriate).

Municipal Bond Market Commentary

From RSW's Q3 2018 newsletter:

"Yields on cash are temporary! Not permanent! When it becomes apparent that the Fed has made a policy mistake they will most likely reverse policy quickly by slashing rates."… "If cash positions are built, long rates can shift rapidly and the opportunity to lock in higher yield levels can be lost"

For the first quarter, tax-exempt bond prices recovered dramatically after a rough go in 2018. In fact, the municipal bond market had its strongest start to a year in over a decade. Contributing factors to the strong performance have been strong inflows, weaker supply, new tax laws, and a strong U.S. Treasury bond market led by a Federal Reserve Board that reversed its monetary stance from "Hawkish" to "Dovish".

In its March meeting, the Federal Reserve declared it is not raising the federal funds rate and hinted it will not hike rates for the rest of 2019. The Fed stated, "growth of economic activity has slowed from its solid rate in the fourth quarter." This sentiment is in contrast to the January statement where economic activity had been "rising at a solid rate."

As of quarter-end, using the 10-year U.S. Treasury bond as a benchmark, yields have declined by 28 basis points to 2.41% compared to "AAA" rated municipal bonds whose yields fell by 42 basis points to 1.86%. With the pace of tax-exempt demand outstripping the level of available bonds for purchase, the ratio of 10-year "AAA" rated tax-exempt yields as a percentage of comparable maturity U.S. Treasury debt fell to 77%. Historically speaking, this is well below the average ratio of 90% recorded in nearly 30 years and nearly 8 ratios higher than the 69% low observed in decades.

The Tax Cut and Jobs Act passed in late 2017 enacted changes that high-tax state residents are starting to feel. Among the changes was a $10,000 cap on the State and Local Tax deduction (SALT), which is easily reached by wealthy investors in states such as California, New York, New Jersey, Illinois and Maryland. These 5 states total over half of the SALT deduction claims and are severely affected by the new bill. To combat the effects of the SALT deduction cap, many investors are opting to purchase municipal bonds. This demand has contributed to pushing yields lower, specifically in high-tax states.

Lastly, as portfolio managers, we continually strive to strike a balance between maximizing the total rate of return/above market tax-exempt cash flow of our client portfolios against the risk necessary to achieve those objectives. While yields have seemingly declined in a straight line since year-end, the next move cannot be called by using the same ruler. In short, we continue to believe that the potential yield fluctuations ahead should provide a ripe environment for RSW's team to adjust portfolio positioning to capitalize on those opportunities.

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