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"Fast and Furious"

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Fast and Furious

While the rest of the world seems to be spiraling out of control, we at RSW remain calm and confident in our disciplined and methodical investment approach. From RSW's issuer selection, to the team's maturity and interest rate positioning, we believe that our clients are particularly well-positioned to weather this economic and social pestilence.

For the first quarter of 2020, virtually every asset class experienced near record levels of volatility with price declines being both swift and decisive. In an unusual occurrence, the tax-exempt asset class did not provide a "port in the storm" as municipal bonds were also struck by spectacular turbulence. In fact, this normally "sleepy" asset class experienced outsized price fluctuations. For example, by the end of February the Five-Year Barclays Capital Municipal Bond Index (benchmark for RSW's Intermediate Duration strategies), had posted an impressive 1.82% total rate of return. However, prices were slammed during March and at the height of the volatility, the Index was (-6.80%.) Prices rebounded dramatically with the Index finishing the quarter at a loss of (-1.04%.)

Slow and Steady

As we did in 2008, we entered 2020 defensively positioned. From our team's tight lending standards, where we only sought to loan monies to the most creditworthy municipal borrowers, to RSW's historically low levels of interest rate risk, we were already braced for impact. In our 2020 Investment Outlook, we cautioned our readers to "Check Your Junk". We added, "It appears that the appetite to assume an increasing level of risk is dissipating…To us at RSW, this shift in the pricing of risk is important to note, as it marks a reversal of the no risk is too big mentality."

With the above being said, we certainly didn't envision COVID-19 being the spark that set our forecasted deleveraging cycle into motion. Simply put, a key reason for our concern was the lack of respect for risk and the resultant lend money to anyone attitude. From individuals, to businesses, to Governments, to the broker/dealer community, the system was drowning in debt. COVID-19 acted as the siphon that caused the liquidity pool to recede and the "no risk is too big" attitude to vanish. When greed yielded to fear, the shedding of leverage began.

"Fear and Greed Tend to Affect One's Judgement"

To us, this period of de-risking had the same "feel" as 1994 and 2008. In both instances, the broker/dealer community entered the downdraft carrying a bloated inventory of bonds. As prices sank, traders were eager to unload their positions, but they were not the only bondholders attempting to liquidate their holdings at that time. Leveraged investors and open-end mutual fund portfolio managers were also seeking bids on their positions.

As is typical, when individuals see the Net Asset Values of their mutual fund investments decline, they begin to panic. In short, there were too many forced sellers trying to fit through a tiny exit door at the same time. With the available supply of bonds dwarfing the number of interested buyers, the bid-to-ask spread (execution costs) also rose to nearly unprecedented levels.

As the crisis gained momentum there were fundamental reasons for institutions and individuals to begin a process of risk reduction. However, it was a dramatic shift in psychology and the interconnectivity of asset classes that caused the debt laden system to convulse. The problem was aggravated further by headlines and pictures of breadlines (ala the Great Depression) as no scenario seemed too impracticable or too negative.

We've Seen This Movie Before

Today, talk of municipal defaults have become commonplace and are reminiscent of two other times where a municipal apocalypse was in the offering. Aside from the Great Recession of 2007-2009, in 2010 Meredith Whitney (Corporate Analyst) forecasted that over the next twelve months, municipal defaults would total $100s of billions of dollars. As fear engulfs the psyche of many investors, the positive attributes and fundamental strengths of municipal bonds are often misunderstood. Some of these are not limited to, but include:

Municipal issuers are not corporations who are in the business of making widgets and therefore are not dependent on consumers to purchase their product to stay in business. Municipalities are "permanent entities" that for all intents and purposes are monopolies that provide essential services based on tax revenues and fees collected.

Moreover, since 2009, many of the higher investment grade state obligors have been busily building-up their cash reserves (rainy day funds) to near record levels to provide a cushion for the challenging times such as these. Many of these issuers are tapping these resources today.

Since the Great Depression, the sophistication of financial internal controls and reporting has improved markedly. Much the same way that corporate America has become more efficient in deploying "just-in-time" inventory practices, governments have become increasingly effective and transparent in monitoring receipts, disbursements, and making necessary adjustments.

Ability to enforce and collect property tax receipts even during the most challenging times: while many individuals are concerned that an increasing pace of foreclosures presents a risk to property tax collection, this is not the case. Property taxes are first in line to be paid (priority lien) and municipal governments can foreclose on the property to recover any unpaid taxes.

Go Big or Go Home

Aside from the unique qualities mentioned above, embedded in the recently passed $2.3 billion CARES Act (The Coronavirus Aid, Relief and Economic Security Act), the Federal Government is making $454 billion in loans and loan guarantees to states and municipalities.

In addition, in order to enhance the liquidity conditions in the municipal bond market, the Federal Reserve is committing to purchase bonds in the secondary and new issue municipal bond market.

At present, uncertainty prevails as to the duration and consequence of the coronavirus emergency. However, the likelihood of a continued economic disruption should continue to put downward pressure on the credit ratings of a variety of issuers.

Shelter in Place

Nevertheless, we anticipate that high investment grade quality municipal obligations will continue to make debt service payments without disruption over the short, intermediate, and long term. Likewise, we remain steadfast in our belief that credit ratings of the issuers to which we have exposure should firmly remain in the investment grade category.

At this juncture, since the Fed's announced plans to "reliquify" the municipal bond market, prices are in the process of recovering and a sense of order has returned to the marketplace. While no one can know how long our economy will be quarantined, we will remain judicious in our disciplined approach to credit quality and interest rate risk.

As always, we will continue to keep you apprised of any meaningful new developments in our Intra-Quarterly Commentaries.

Be safe and stay well.

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