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RSW's Q1 2021 Fixed Income Newsletter

"Are We Clear?…Crystal"

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With the first quarter behind us, thus far, RSW's economic and interest rate forecast for the year is developing as anticipated. To paraphrase, in our 2021 Investment Outlook we said:

"With Washington continuing its full-throttled emergency response to the pandemic, over the near-term we would not bet against their ability to foster greater levels of growth. To us at RSW, one thing is for certain: More is on the way!"

- More Congressional approved fiscal stimulus.
- More tolerance for higher levels of inflation.
- 10-Year U.S. Treasury bond yields should rise from the current level of 0.95% to 1.75% in the first half of the year followed by a decline to 1.25% by year-end.

Is the Coast Clear?

While we projected a 90% increase in the yield of the 10-Year U.S. Treasury bond and our target of 1.75% has been reached, we are <u>not</u> ready to release our defensive portfolio positioning. Although it is possible that the recent peak in yields could remain in place for weeks to come, the speed of the move, continued government deficit spending, robust consumer spending, and rapid price appreciation in the equity and high yield bond markets argues for another yield surge in the second quarter. With fixed income participants on edge, the Federal Reserve's new mission is to provide an assurance to the bond market that even as the economic backdrop improves, a continuation of a low interest rate policy will not cause the rate of inflation to gather lasting momentum.

No Clear Path to Declare Victory

To us at RSW, the path that Federal Reserve Chairman Jerome Powell charted has led to an inevitable "catch-22". So, what is the conundrum and why can't Washington officials declare a victory in the fight against the COVID induced slowdown?

Powell's low interest rate policies (the Fed can only "control" short term rates), combined with his appetite for vast amounts of Congressional "rescue spending", have certainly created their desired "sugar rush" of economic strength. However, potentially offsetting this benefit is the bond market's reaction to these policies. Namely, that vast amounts of government spending equals vast amounts of government borrowing. Elevated levels of new-issue supply pushes interest rates higher. Stronger economic activity puts upward pressure on inflation. Higher levels of inflation also cause market rates to rise.

With that being said, there is no reason for us to alter our forecast that yields should begin their decline in the second half of the year. We must be mindful that the foundation of our country's economy remains fragile against a backdrop of an aging population, mediocre income growth, and a highly leveraged U.S. economy.

This dynamic combined with rapidly rising rates should squelch the future pace of economic activity. So, while the Fed desires stronger growth and higher inflation, it is the higher rates that follow that should usher in the next deflationary cycle.

For those who remain unconvinced that rising yields cannot be sustained, we need to look no further than the communications and directives coming from the world's Central Bankers. For example, on March 11, European Central Bank (ECB) chief Christine Lagarde said that the recent rise in bond yields could have an "undesirable" impact on the economic recovery. Therefore, to force yields lower, the ECB is planning to increase their bond purchases "at a significantly higher pace than during the first months of this year"[1]. Based on their communiqué, you would think European rates are soaring "off the charts". Clearly, that is not the case. For example, today, the yield on the German 10-Year government bonds sits at (-0.27%). From a low yield of (-0.86%) [1]. No, that's not a typo, that's minus (27) basis points.

The actions taken by European Central Bankers send a strong signal that higher rates will not be tolerated. In our opinion, at higher rates, Powell will likely follow-suit and attempt to cap market yields by purchasing longer-maturity U.S. government bonds. From that juncture, the shift to higher bond prices (lower yields) could be swift. Are we clear?…Crystal.

Municipal Commentary

Notwithstanding the spike in 10-Year U.S. Treasury bond yields, market rates for comparable maturity high quality tax-exempt bonds have risen approximately half as much. Therefore, while the municipal bond market is currently providing a modest amount of enhanced income compared to the start of the year, the compensation versus the risk of materially increasing our interest rate sensitivity (duration) remains unexciting. In addition, as is often the case during March through April, the pace of new issue supply is poised to rise and should serve to put upward pressure on municipal bond yields. With the above being said, we are choosing to remain strategically patient until we are more adequately compensated for higher levels of interest rate risk.

Pandemic Relief Act III: No Strings Attached

The $1.9 trillion American Rescue Plan (ARP) signed into law in March differs significantly from the two previously enacted Coronavirus Acts that provided only indirect relief to state and local governments by earmarking funding for pandemic related costs only. The ARP provides for an approximate $350 billion cash infusion for municipal entities to cover costs and or replace lost revenues. In short, they are receiving virtually a blank check with minimal restrictions that can be drawn upon as needed through year-end 2024 [2].

[1] Data Source: Bloomberg

[2] Data Source: Wall Street Journal

State governments will receive $195 billion allocated by a formula based on unemployment over the last quarter of 2020. California, New York, Florida, and Texas will each receive more than $10 billion with other states receiving somewhat smaller allocations [3].

Some Background

State and local governments, on average, during the first 3 to 6 months of the pandemic, experienced rapid revenue declines and uncertainty that made revenue forecasting and budget planning extremely difficult. States took various actions from drawing down on reserves, to kicking the can down the road, to raising taxes and to resorting to deficit financing (i.e., New Jersey's $4 billion deficit bond issue).

Revenue growth took a turn for the better during the second half of the pandemic for many jurisdictions. Various local economies began to open, enacted federal relief aid bolstered the safety net, and it became clear that higher income taxpayers and consumers were not as negatively impacted as projected. State governments such as New York, California, and Connecticut have experienced significant revenue growth from capital gains as the equity markets advanced.

The volatility in revenue forecasts is best illustrated by California. The FY 2021 revenue forecast of only $125 billion represented a $25 billion reduction from FY 2020. Actual fiscal year revenues for FY 2021 were reported to be $28 billion higher - $153.6 billion, with FY 2022 revenues projected to be $161 billion [4].

This Begs the Question - Do the States Really Need These Funds?

This is not within our purview to address. The real question is how will the various state and local governments use these funds, especially those with weaker credit ratings and/or poorer recovery prospects? New York and Hawaii differ from the California example as the ARP funds represent a much-needed boost.

Keep in mind, these funds are a "one shot into the arm"- not a recurring revenue source. Many questions remain:

- Will legislatures use these funds to continue unsustainable spending not matched by recurring revenues?
- Will new "pet projects" be undertaken?
- Will these funds be used to replenish rainy day funds?
- Will states have the discipline to use these funds judiciously through 2024 and not burn through them?

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[3] Data Source: Wall Street Journal

[4] Data Source: Standard and Poor's

Going forward

It is these questions that will chart the course of future credit and investment decisions. Nevertheless, keep in my mind that we start from a position of strength as the average credit rating of RSW holdings is securely within the "AA" category.

It is also worthy to note that, during the course of the pandemic to date, Standard and Poor's (S&P) only downgraded three states: Alaska, Wyoming, and New Jersey. S&P also downgraded 115 municipal credits during this time frame, the vast majority in sectors that we avoid or have minimal exposure.

Some Footnotes

The section above titled "Pandemic Relief Act III: No Strings Attached" made mention of the "political" restrictions on the application of ARP funds. They are as follows:

> 1- Funds cannot be used to finance unfunded pension liabilities. This is whimsical as it frees up other monies to dedicate to pensions.
>
> 2 - Senator Schumer is reported to have inserted language into the legislation that bars states from accepting these funds if they take any action to lower their taxes through 2024. Whether this is constitutional is a legitimate question.

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