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RSW's Q1 2022 Fixed Income Newsletter

"Is the Federal Reserve Triggering a Minsky Moment?"

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Is the Federal Reserve Triggering a Minsky Moment?

At RSW, we have always put a premium on candid communication, whether our forecasts were unpleasant or reassuring. As always, our goal is to present an objective viewpoint in a manner where we are not a perpetual "cheerleader" for the municipal bond asset class nor reflect a belief that Central Bankers can save the planet.

Today, Federal Reserve (Fed) Chairman Powell faces a predicament that rivals those of any previous Fed leader. In fact, after years of Congress feeding the economic beast with unprecedented levels of fiscal (trillions outlaid through deficit spending and "Covid relief" bills) and monetary stimulus provided by the Fed (zero percent rates and Quantitative Easing (QE)), investors believed that Washington not only had their backs, but their backsides too.

Economist Hyman Minsky pontificated that "stability" in and of itself is "destabilizing". He posited that extended periods of above average economic growth leads to a boom in the demand for credit. As the mood of borrowers shifts from one of prudence to outright complacency, he further suggested that this irrational behavior spurs decision makers to deplete their liquidity positions and assume above average debt loads. According to Minsky, extreme speculation will eventually lead to a crisis and the longer the periods of excesses last, the more acute the crisis.

Excesses Eventually Falter

With financial leverage at pre-pandemic highs due to the shift toward increasing levels of risk, the ability of the economy and financial markets to withstand even modest adverse shocks has been weakened. One way to look at financial leverage as it relates to the financial markets, is the level of margin debt. This represents the amount of money that an investor has borrowed against their investment portfolio. Recently, there has been a surge in the number of investors accessing funds using their holdings as collateral. Total margin debt is now near the highest amount on record, dwarfing 2008 levels by over 40% (source: FRED, March 10, 2022).

Although interest in speculative investments remains near the highs, consumer confidence in the broad economy is collapsing. In fact, the University of Michigan Consumer Sentiment Index recently dropped (March 25, 2022) to its third lowest level since 1990 and is nearing the low reached during the 2008 financial crisis (source: Bloomberg).

Evidence of waning confidence can also be found in the high yield corporate bond market where investors are showing greater reluctance to lend money to the least credit worthy borrowers. Specifically, for those issuers that carry a credit rating of "CCC" (one notch above default) investors are demanding a higher premium or spread to comparable maturity U.S. Treasury debt to purchase those bonds. Since June 2021, after shrinking to the lowest levels since 2007, the additional yield that investors require to purchase the bottom tier of "junk bonds" has spiked by roughly 30% (source: Bloomberg, March 23, 2022).

Against the backdrop outlined above, the Atlanta Federal Reserve downgraded their GDP forecast for the first quarter of 2022 to just 0.9% on March 24, 2022. This compares to a 6.9% growth rate recorded in the fourth quarter of 2021. At RSW, we remain convinced that a negative growth rate lies ahead and that the second quarter's economic activity should be markedly weaker than that of the first period.

Moreover, we project that consumer spending will decline from current levels. With the Consumer Price Index spiking to the highest levels in four decades (source: Bloomberg, March 10, 2022), consumers may be forced to slash their discretionary spending budget as the cost of necessities continues to climb sharply and the growth in wages sinks below the rate of inflation. To that end, real earnings (after inflation) are down (-2.6%) (Source Bloomberg, March 10, 2022) from a year ago, which is weaker than the period during the Great Recession.

The Slope of Hope is Becoming the Curve of Caution

Other warning signs that are indicative of a faltering growth rate are emerging. One that we monitor closely is the slope of the U.S. Treasury bond yield curve. Normally, the "curve" is upward sloping as investors expect greater compensation (higher yields) for the risk that inflation rises in the future. Although the level of compensation, or yield differential, fluctuates, a bond that matures in 10 years will typically offer a higher yield that one maturing in two years. Today, the gap between the two securities has collapsed to just 5 basis points (0.05%) (Source: Bloomberg, March 29, 2022) from this year's opening level of 78 basis points and a 12-month high of 158 basis points.

Should the yield of a 2-year note exceed that of a 10-year bond, this is known as an inverted yield curve. This occurs as bond investors seek to lock in yields for longer time periods as the likelihood of the Federal Reserve reducing short term rates in the future becomes likely. With history as a guidepost, such an event sends a strong signal that a U.S. recession is on the horizon. It is also important to note that inverted yield curves have always been precipitated by a Federal Reserve that has been too aggressive in tightening monetary policy.

While some remain unconcerned about the relationship between short and longer-maturity rates, at RSW, we are certainly not dismissive. To provide some context, there have only been two occasions that 2-year yields have exceeded those of 10-year bonds since RSW began operations in 2005.

The first inversion occurred in 2006. In RSW's Q1 2007 commentary 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".

The second inversion occurred in 2019. In RSW's 2020 Outlook we forecast, "While most are breathing a sigh of relief and feeling upbeat about our nation's economic prospects, we are poised to once again fade the opinion of the masses … In fact, we believe that the recent optimism is misplaced and that a financial event could be unfolding".

Is the Fed's Continued Streak of Policy Mistakes a Certainty?

A reopening of the world's economies and supply chain issues, exacerbated by a wall of government supplied fresh cash, have caused the inflation rate to soar to levels not witnessed since the 1970's. While the Federal Reserve was inactive for close to a year, claiming that the surge in inflation was transitory, they have ended their QE program.

With the Federal Reserve purchasing close to a trillion dollars in U.S. Treasury and mortgage-backed bonds annually, the cessation of this QE policy drained liquidity from the financial system. In effect, the implementation of this Fed tightening policy contributed to the substantial rise in market yields.

Concurrently, the Fed has planned a string of rate hikes that span well into 2023. Against an unblemished track record of the Federal Reserve being on the wrong side of their interest rate decisions, could the Fed have waited too long to tighten monetary policy and are now planning to do too much? Historically, worries about surging bond yields led by Fed rate hikes traditionally crop-up when the economy and inflation are surging. This time, however, economic activity is faltering amidst bloated levels of debt and a consumer that remains under siege from broad based inflationary pressures.

Premise or Price?

Although unwritten, bond yields have exceeded RSW's targeted levels. Our goal, however, is not to call tops and bottoms to the basis point, but to identify themes and strategically manage to them. As always, we must ask ourselves if it's just price that was violated or also our premise?

The bond market is just like any other market in that prices will fluctuate moving from "overbought"-to-"oversold" and back again. For active high quality bond managers, these changes either present opportunities to reduce the interest rate risk profile of our client accounts or an opportunity to enhance the portfolios fluctuations in market value.

For example, in RSW's 2021 Outlook we said, "Many casual investors believe that if the Federal Reserve maintains a zero percent overnight rate policy that market yields for bonds of all maturities will remain 'well-behaved'. Well, fasten your safety belt because history shows scant evidence of that".

In the 2022 Outlook we added, "[…] once the Fed goes into motion and begins to hike rates, longer-maturity bond yields should rise as well. This is the part of the cycle that we are patiently awaiting and believe that the next rate hike campaign should be a relatively swift one".

In concert with our outlook, while still attempting to capture a relatively high level of cash flow, we positioned our client portfolios in a relatively defensive manner for such an interest rate shift. Since that time however, as rates have surged, we have patiently and methodically maneuvered the interest rate risk of our client portfolios to a relatively neutral stance.

Conclusion

From the lows of 2020, asset prices, led by the equity market, have provided explosive returns. Against this backdrop of rising prices, comfort levels with lesser quality investments continued to rise, thrusting investors into an extreme case of complacency. In fact, amidst this year's bond market rout, some investors are sounding the alarm that bonds, not stocks, are the biggest threat to their portfolio's stability. Given the extreme movement in rates these emotional responses are both reasonable, expected and often necessary to complete the pattern of a cyclical rise in yields.

However, we believe investors are focusing on the asset class that has already or mostly completed its price adjustment. As we have observed in past sequences, the combination of an upward correction in interest rates and the skyrocketing cost of essential items, siphons money from household budgets. These forces, as we have witnessed over the years, should serve as a self-breaking mechanism as they exert downward pressure on future economic growth.

At this juncture one must ask themselves the following question: could it now be possible that sinking U.S. Treasury bond prices (rise in yields) are the catalyst, or "final blow", that activates Minsky's "destabilizing" forces? We await signs of this event and stand ready to extend our interest rate positioning yet again to capitalize on the precipitous decline in yields that we believe lies ahead.

Municipal Bonds

For active municipal bond managers or buy and hold investors, the first quarter of 2022 proved to be an abysmal start to the year as yields surged and prices declined.

Notwithstanding RSW's forecast for rising rates and related relatively short duration (measurement of interest rate sensitivity) positioning, at the end of the day we are investing in a market that went "south" with atypical speed and breadth. As is the case with all liquid assets, prices continuously fluctuate and in the case of municipal bonds, the variations are often tethered to the yield and price changes witnessed in the U.S. Treasury bond market.

As is usually the case, the amount of mutual fund redemptions has been heavy during this period as investors reacted to the Fed's intended rate hike schedule and resultant spike in market yields. In addition, with respect to the tax-exempt mutual fund arena, selling often begets selling. This style typifies the behavior of some individuals, where historically, the largest inflows of monies are near the peak in price and the maximum outflows occurs at the troughs.

During the last 11 weeks investors have yanked approximately $20 billion from funds (Source: JPM). To put this volume of redemptions into context, for all of 2020, bond fund outflows totaled roughly $48 billion (Source: JPM). As mutual fund portfolio managers receive the withdrawal requests, they must sell bonds from their portfolios to raise the necessary funds to meet the shareholder request. With managers seeking to obtain vast amounts of liquidity from a broker/dealer community that is already experiencing sharp losses, they drop their bids to below "market" prices.

Although we believe that the end is near for the U.S. Treasury market sell-off we must be mindful of the internal characteristics of the municipal bond marketplace. It is incumbent upon us to follow the liquidity situation closely as the dynamics during challenging periods often change with the speed of flipping a light switch. Historically, these periods have created strong opportunities for us to lock-in higher rates and believe today's challenging times will present the same prospects in 2022.

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