December 15, 2022

RSW's 2023 Investment Outlook

"NOPE"

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“NOPE”

A science fiction horror western movie titled “NOPE” was released in theaters during the summer. While the film began as intriguing and suspenseful, it quickly devolved into a disturbing, ridiculous, and confusing mess. Similarly, many investors would describe this year’s investment landscape using those same adjectives.

The key drivers of these attitudes were as follows:

- Monumental stimulus flowing out of Washington DC following the pandemic, combined with Fed policy that was too loose for too long, caused rife speculation and extreme price levels.
- Inflation, once labeled as “transitory” by the Federal Reserve, increased parabolically during the year hitting forty-year highs.
- Realizing that their inflation forecast was scripted poorly, the Fed scrambled to tighten the money supply by shutting down their Quantitative Easing (QE) program and reversed course by adopting a Quantitative Tightening (QT) strategy.
- Next, to “Whip Inflation Now”, the Fed aggressively hiked interest rates by lifting the overnight borrowing rate from 0% to 4.25%.
- As the Fed employed their double-barreled approach to kill inflation, longer-maturity bond yields surged, economic activity slowed, and the prices of many asset classes convulsed.

Review of RSW’s 2022 Predictions and Actions

In RSW’s 2022 Outlook we attempted to prognosticate and make sense of it all as it pertained to our interest rate risk management approach:

- “Traditionally, by paying too much attention to today’s economic data the Fed misses the ‘turns’, ‘overtightens’, and causes the next recession.”
- “While we agree with the market’s overall assessment that future Federal Reserve actions should result in a policy misstep, it’s too early to prepay for the possibility that yields will decline by purchasing highly interest rate sensitive bonds today.”
- “While we are restless and eager to earn a modest amount of additional income today by taking on greater levels of interest rate risk, we must continue to resist that urge.”

As interest rates surged in the first half of the year, in June, we sought the opportunity to release a “Strong Buy” recommendation (fourth such suggestion in RSW’s 17 year-history) for municipal securities. We believed that rates were in the process of peaking and that the Fed’s anxiety about rampant inflation would yield to the poor health of the economy and financial system. In September, against a continued backdrop of rising market yields we again reiterated our “Strong Buy” endorsement suggesting that the higher levels of rates are just not sustainable.

To be frank however, by the close of this year, while there are pockets of rot in the financial system, broadly speaking we had anticipated that systemic issues would have already forced Chairman Powell’s hand to reverse policy. However, just because the “risk” markets, financial system and economy are in a relative state of calm, are we not sounding the “all clear” signal. Please read on.

2023 Forecast

Analogous to the movie “NOPE”, what we are observing today is a spectacle of ridiculous proportions that is unfolding in slow motion. Over the decades, we can recall only a handful of challenging periods that could be described as calamitous, but the texture of this episode feels different. To that end, this commentary will not be dedicated to repeating fairy tales produced by the Federal Reserve, et al. Instead, this report will be an authentic assessment of our nation’s predicament.

Maintaining cheap money for extended periods of time without any repercussions, such as surging inflation, was a fairy tale promoted by many economists, pundits, and those in Washington. Chairman Powell was a key “actor” in this tragedy as he promoted his “money for nothing” agenda by promising to keep short-term rates at zero percent through 2023. This fallacy caused a repricing of virtually all assets and changed the attitude of borrowers from prudence to outright complacency, to downright irresponsibility. Furthermore, this euphoric mood shift sparked irrational exuberant behavior among decision makers as they depleted their liquidity positions and assumed above average debt loads.

In 2021, while most enjoyed the party of spending and rising asset values, in 2022 the hangover from the celebration trampled the mood, as the annual pace of GDP is likely to post a meager 1% growth rate. With that said, we believe that the situation is likely to be worse next year. For the last 19 months, the pace of wages has trailed the rate of inflation. To make up this difference, individuals utilized various strategies to pay their basic cost-of-living expenses.

Holding down multiple jobs, drawing upon their savings to levels that are near the lowest in history, and amping up their credit card debt to record amounts are just some of the measures being employed. To us, the above is a warning sign that consumer spending, which comprises approximately 70% of GDP, is set to slow dramatically as individuals are running out of means to be self-sustaining.

It’s no wonder why consumer confidence remains near the lowest level in 44 years and credit card defaults at the smallest banks are experiencing failure to pay incidences at a pace that is close to those amounts experienced during the height of the pandemic (Source: FRED, Nov 2022). As you would expect, this has negatively impacted the cost and availability of credit. In fact, today, the average interest rate for a card is approximately 20% and stands at the highest level since the early 1990s (Source: FORBES, Nov 2022). Against a backdrop of an escalating default rate, the number of banks that are tightening their standards for credit cards loans has soared, making it more difficult for individuals to access credit (Source: FRED, Nov 2022).

The housing market should also be an important sector of the economy where cracks in the foundation are plainly evident. Comprising roughly 17% of GDP, the extreme weakness that we believe is in the offering could be one of the strongest headwinds to economic activity. Examples of fissures include:

- Housing affordability is at the lowest levels on record (Source: Bloomberg, Dec 2022).
- Homebuyers are facing payment shock and cancelling their new single family home building purchase contracts at the fastest rate since the beginning of the pandemic (Source: Redfin, Sep 2022).
- In November, the National Association of Home Builders (NAHB) sentiment index dropped again, for the tenth straight month, falling to the lowest levels since 2012.
- Single family home sales have fallen nine months in a row to the lowest levels since 2011 (Source: FRED, Nov 2022).
- Case-Shiller Home Price Index shows price growth decelerating at a record-setting pace.

Although some economists and investors dismiss the “housing bubble” as a sector event and not of global concern, just as we did in 2006, we remain skeptical today. With this engine of growth shutting down, it is not a stretch to believe that the massive debt that has been built up to support these inflated home values may become problem loans. The deflationary effects of a housing debacle, an implosion in the demand for credit, and a weakening job market (currently stable), should soon become evident.

Nope, Just Nope

Against the backdrop outlined above, the is a growing chorus of CNBC types and “experts” that the Fed is on the verge of a “pivot”. In other words, when will Powell reverse his interest rate hike campaign and begin to reduce the overnight lending rate? This is the same crowd who drone on about the possibility that the Fed can slay massive inflationary pressures, by hiking rates, and not cause a recession.

To us, this “soft landing” scenario is at best wishful thinking. In fact, the debate should have been laid to rest after Chairman Powell recently signaled that he stands ready to engineer a recession and is prepared for the U.S. to suffer the consequences. In other words, according to Powell, the risks of not fighting inflation unconditionally poses a larger risk than acting with a softer approach. His rhetoric remains in concert with RSW’s second quarter 2022 forecast that: “the Fed will only conclude their plan of tightening monetary policy after they break something.”

At this juncture, Chairman Powell remains on a collision course with the financial system despite one of their key metrics flashing bright red, the shape of the U.S. Treasury bond yield curve.

The Sequel

Today, the shape or “slope” of the yield curve has been making headlines. In its simplest form, the yield curve is a pictorial representation of interest rates on bonds with differing maturity dates. While the Federal Reserve exerts significant control over short term market rates, it is the future expectations of market participants that determine the yields of longer maturity bonds. If investors are upbeat about U.S. economic prospects and believe that those solid results will produce stronger inflationary readings, then they will likely demand higher yields to lend monies for longer time periods. Of course, the opposite is also true, and this is where we find ourselves today.

As we discussed in the first quarter’s commentary, an interesting phenomenon has developed during the Fed’s latest interest rate hike campaign. Currently, the yield curve is “Inverted” as market rates on three-month U.S. Treasury Bills are higher than bonds maturing in 10 years. At first glance, an inverted yield curve seems illogical. Why would investors lend monies for longer time periods while settling for lower yields than short-term investors? The answer is that long-term investors will settle for lower yields now if they believe that interest rates will be even lower in the future. Said differently, the inversion in the U.S. Treasury market should be seen as a bad omen as market participants are overwhelmingly speculating that the Federal Reserve’s policy actions may tip the economy into a recession and thus need to quickly lower rates at some time in the future.

To frame the significance of what is taking place, the yield on three-month U.S. Treasury Bills currently exceeds the rate on ten-year maturity bonds by 87 basis points, the largest “inversion” in history. Not only has this event unfolded in each of the last eight recessions (Source: FRED, Dec 2022), but it appears that the more “hawkish” the Fed speak has become, the more pronounced the inversion of the yield curve is trending.

Third Installment

Looking further ahead into 2023, we believe that the yield curve should “un-invert” with short term yields again falling below longer-maturity bonds. The pundits will almost certainly cheer and celebrate that this event is a sign that the good times are about to roll. Will that be justified? NOPE! Given the extreme nature of the current inversion, a “hard landing” for the economy is RSW’s base case scenario.

A financial and/or economic event is thus likely and should cause shorter maturity yields to drop significantly. The Federal Reserve, prone to be late, should then follow the lead of the bond market by reducing the overnight Federal Funds target rate. This time around however, Chairman Powell’s options will be limited. Flooding the system with money this time around should only reignite a spike in the rate of inflation. Therefore, should our thesis prove correct, and the Fed acts in a more restrained matter, it almost ensures that a protracted economic recession lies ahead.

Bottom line: Using the 10-year U.S. Treasury bond yield as a barometer, we believe market rates are set to fall dramatically from current levels. Therefore, our base case is 2.25% - 2.50% by year end. Should the path to lower rates be interrupted and another yield surge emerge, we will view that rise as another solid opportunity to “take a bite out of the apple.” Against the backdrop discussed above, we strongly believe these rate levels just aren’t sustainable.

The topics and our outlook may seem like they’re written for a “B”-rated movie; disturbing, ridiculous, and confusing mess. While some of our competitors may take copious notes of Fed utterances and stay on “pivot” watch to contemplate their next mistake, we will continue to stick with our projections, rather than react to each number from incoming data. Should anyone manage money based on the declarations of the Fed? NOPE, we just don’t care!

RSW’s Perspective on the Municipal Bond Market

Municipal bond investments have long been considered the “boring” allocation of an individual’s portfolio. In 2022 however, this resolute asset class, was upended by a surging rate of inflation and a string of outsized Federal Reserve rate hikes. As of this writing, for the year, the broad-based Merrill Lynch Municipal Bond Index (MLBI) posted a loss of (-7.83%) with ten-year “AAA”-rated tax-exempt rising by a whopping 144 basis points.

The change in the direction of interest rates was significant as the yield surge did not occur in a straight line. For example, in the first quarter, the MLBI was down (-6.23%) the worst quarterly return in 40 years, and in the month of November the market was up (+4.68%), the best total rate of return in nearly 40 years.

In the world of fixed income, rising interest rates are no cause for celebration as the prices of the bond holdings will certainly lose value in a rapidly rising rate environment. With what could be considered the worst year for the tax-exempt bond market, RSW’s portfolios held-up relatively well. Our methodical investment approach was instrumental in mitigating the depreciation experienced in the portfolios. By entering the year with a level of interest rate risk that was meaningfully lower than that of each strategies’ respective index we were able to capitalize on periods of rising rates by enhancing our portfolios’ level of interest rate sensitivity and increase the average earning yield.

Looking ahead, as was discussed in the general commentary section, we do believe that interest rates are likely to decline precipitously. As of this writing, we have the average duration (measure of interest rate sensitivity) higher when compared

to our index. With that said, we do believe that the level of interest rate fluctuations is likely to be high and provide our team with solid opportunities to initiate adjustments should our outlook change.

Lastly, in terms of credit quality, we believe state and local government balance sheets are extremely well positioned at the start of 2023 to meet the anticipated economic slowdown. This was not the case during the "great recession" of 2008-09. Municipal government revenue declines during the recent pandemic were not as severe as originally feared and the influx of billions of dollars to the states and transportation authorities bolstered balance sheets to relatively strong levels. This has fueled a surge in state surpluses, including rainy day funds, which have doubled over the past two years from pandemic levels. Therefore, we anticipate that high quality general obligation and revenue backed municipal credits will have the resources and capacity to counter any slowdown in tax receipts and/or revenues.

As always, RSW's strategy continues unabetted in adherence to our strong discipline with respect to credit risk. This strict discipline has allowed us to steer clear of various challenges encountered along the way including the 2008-09 recession, the Covid crisis, the Puerto Rico default, the unfunded pension crisis, and a host of various other smaller disruptions.

Happy Holidays and Thank You for your trust and confidence in maneuvering through these challenging market conditions.

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All performance referenced is historical and is no guarantee of future results.