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RSW's Q2 2018 Fixed Income Newsletter

How Long Can the Federal Reserve Hold a Plank?

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While it's true that performing a plank (a full body exercise) can strengthen your core, the same cannot be said about the yield curve which has a plank type shape. Here, the ability for the yield curve to hold a plank position connotes troubles that are associated with a weak core. The masses are now all over this theme, as it has become mainstream to talk about the "flattish" shape of the U.S. Treasury bond yield curve (typically longer-maturity debt affords higher yields relative to shorter-maturity bonds). While we addressed this topic in RSW's 2018 Investment Outlook, as you may have already concluded, we're by no means finished expressing our views.

As you recall, in the wake of the financial crisis, the Federal Reserve embarked on a monetary policy experiment known as "Quantitative Easing" (QE). In this program, the Fed enlarged the size of their balance sheet and purchased a mix of bonds (U.S. Treasury, mortgage and asset-backed securities) totaling more than $4 trillion. Purchases were intended to reduce the cost of long-term borrowings to encourage greater amounts of consumption and investment.

While all eyes have been squarely focused on the Fed's rate hike campaign, government officials have also been engaged in another grand financial experiment known as "Quantitative Tightening" (QT). QT is the mirror image of QE as it involves draining money from the financial system, serving to raise interest rates. The drain occurs as the central bank purchases fewer assets from financial institutions, thus effectively reducing the amount of money banks can lend. All things being equal, this should raise the cost of money to borrowers.

Given the Federal Reserve's two pronged approach (rate hikes and QT) to tightening monetary policy, many pundits were looking for long-term bond yields to soar. To date, while longer maturity yields have indeed risen, short-term bond yields have accelerated at a faster pace. In fact, during the quarter, the difference ("spread") between ten-year U.S. Treasury bond yields and two-year U.S. Treasury note yields reached a high of 55 basis points and ended the quarter at a low of 30 basis points. This was the lowest yield differential recorded since 2007.

Under normal circumstances (who knows what's normal anymore), bond investors demand a greater yield premium to purchase longer-maturity bonds. However, when investors believe that the Fed is acting too aggressively in tightening monetary policy, the yield curve flattens as forecasts for continued strong growth and higher inflation are called into question. So, in spite of some excellent recent headlines:

NEW YORK TIMES: "We Ran Out of Words to Describe How Good the Jobs Numbers Are"

CNBC: "The US Economy Suddenly Looks Like it's Unstoppable"

Wall Street Journal: "Economic Growth in U.S. Leaves World Behind"

Our nation's high levels of debt and related escalating interest expense payments are causing the U.S. economic muscle to atrophy. Some examples:

- Over the next five years, companies will have to refinance close to $4 trillion of bonds which is equivalent to two-thirds of all their existing outstanding debt (Wells Fargo Securities). The majority of this debt (75%) is rated just a notch above "junk", with the balance of the debt being high yield corporate bonds ("junk").
- Individual home loan payments are rising as many adjustable rate mortgages are tied to LIBOR (benchmark rate that some banks charge each other for short term loans).
- According to the Federal Reserve Bank of NY, household debt scored another record and is currently half a trillion dollars higher than the 2008 peak.
- Personal savings as a share of disposable income is falling rapidly and is near 2007 levels.
- Business Insider (4/10/18): According to the American Bankruptcy Institute, Chapter 11 bankruptcies spiked 63% year-over-year in March…highest number of filings for any month since April 2011.
- Subprime auto-loan delinquencies have surged to the highest rate since October 1996.

No! We are not talking about doom and gloom here, but we remain steadfast in our forecast that the current pace of faster economic activity is not sustainable. The interest payments on the bloated levels of debt should act as a formidable force against long-term "trend" type growth.

At the end of the day, credit growth must be converted to a continuous cycle of wage gains to drive the velocity of money and the pace of GDP higher. Right now we have neither. With 70% of our economic activity being driven by the consumer, our nation has leaned on growing debt levels to make up for the loss in middle class purchasing power. Now, however, with private sector debt at the highest levels in history and the personal savings rate at the lowest levels since before the financial crisis, the consumer is becoming exhausted. Could this be the reason why the yield curve is flattening as the Federal Reserve hikes short term rates? Long-term bond investors are paid to look beyond today's headlines and project where inflation and economic activity will be in the future.

The Federal Reserve's tightening campaign described above, has not only served to flatten the yield curve in the U.S., but their actions have also served to inflict global suffering. In fact, massive pain has been felt in many emerging market economies and currencies. These countries are among those that have borrowed funds by selling bonds denominated in U.S. dollars. To this end, total issuance of U.S. dollar-denominated bonds by emerging market countries has doubled to more than $11 trillion between the end of 2007 and September 2017, according to the Bank for International Settlements.

Why the pain? Simply put, as the Fed hikes short term rates, the U.S. dollar appreciates as global investors search for the highest relative yields. This puts downward pressure on a nation's local currency and upward pressure on their interest expense. This occurs as a greater amount of local currency is now required to purchase "greenbacks" to make the required interest payments.

Highlights:

- Argentina, Brazil, Venezuela are among South American countries that are beginning to reel.
- Brazil's currency, the Real, has depreciated roughly 16% versus the U.S. Dollar (USD) since March 1, 2018.
- As the Peso has declined by roughly 27% since March, 1, 2018, Argentina's financial stability is similarly experiencing high levels of stress. With their daily interest rate skyrocketing from 25% to 50%, Argentina is in bailout talks with the International Monetary Fund (IMF).
- Venezuela's economy is in tatters as their rate of inflation is rising by numbers that are almost incalculable (in the thousands of percentage points).

At RSW, we have had the good fortune of working with some of the industry's most prominent Financial Advisors. They have long realized the value in managing client expectations and asking them to take a serious look at how their portfolio will perform in a world where the financial markets are trading independently of government support (zero percent interest rate policies "ZIRP" and QE). This environment is riddled with never been tried before policy experiments and a complacent or static approach should yield relatively poor risk adjusted returns.

Now, to directly answer the question posed in the title of this musing, Q: How long can the Federal Reserve hold a plank? Our answer is the same one that we provided in our 2007 commentaries: A: "With the benefit of history, the Fed is likely to hike rates until they cause something to break" (recession/and or financial event). Against a backdrop of continued rate hikes, we continue to believe, as we did on May 16, 2018 (10-year U.S. Treasury bond yields at 3.10%) that longer maturity bond yields should continue to work their way lower. In the event our outlook changes, we will of course alter our portfolio management technique and share our views which can always be found in the "Market Insights" section of our website www.rswinvestments.com.

Stay tuned.

Municipal Bond Market Commentary

Recap

During the second quarter, municipal yields rose as selling pressure accelerated in the U.S. Treasury bond market. After 10-year "AAA"-rated bonds reached a high of 2.55% they gradually moved 9 basis points lower to finish the period at 2.46%. For comparative purposes, U.S. Treasury bonds were a bit more volatile as their yield declined 28 basis points from the highs to settle at 2.84%. Looking ahead, it is widely anticipated that municipal bond new issue supply should dissipate, while demand should increase as investors are flush with cash from maturing securities, bond calls and coupon payments. This imbalance has typically resulted in the relative out-performance of municipal debt compared to U.S. Treasury bonds. In fact, July 2018 will have the largest amount of bonds maturing in any month ($32.6 billion) since the inception of the Municipal Bond Market. Our optimism is more muted however, as there has been a reduced demand from banks and insurance companies as a direct result of the Tax Cuts and Jobs Act.

Noteworthy Events

The Supreme Court ruled in a pair of cases at the end of their session that have potential impacts on the Muni Market. The first sets a precedent for sales tax collection as it paves the way for online tax-free shopping to disappear. In a 5-4 decision, the court ruled in favor of the States in *Wayfair v. South Dakota* which overturned the 1992 *Quill Corp v. North Dakota* ruling. Now, irrespective of whether a retailer has a physical presence in a state, a sales tax must be collected. The 1992 ruling held that a corporation did not need to collect sales tax for transactions in states for which it did not have a physical presence.

The emergence of e-commerce and cross-state internet sales since the 1992 ruling has caused a drag on sales tax collections as less customers leave their homes and opt to shop online. Washington, Texas, Florida and South Dakota rely heavily on sales tax collections to fund their budgets as none of these states levy an income tax. Washington (Aa1/AA+) and Texas (Aaa/AAA), two of our biggest holdings, benefit from business-friendly economies and stand to collect on the ruling.

Many issuers such as the Dallas Area Rapid Transit Authority, Massachusetts Building Authority and New York Dormitory Authority issue debt that is secured by pledged streams of sales tax revenue. These and other sales tax secured bonds also stand to gain from the ruling. According to the Wall Street Journal "the court cited studies suggesting that the current rule costs states up to $33.9 billion a year in uncollected sales taxes".

The court also ruled in favor of public workers in *Janus v. American Federation of State, County, and Municipal Employees* which is considered another win for the States. At issue was whether Illinois State public worker Mark Janus should be required to pay an agency fee to his local union. In a 5-4 decision, the court ruled that being forced to pay an agency fee to an organization that is political in nature is a violation of first amendment rights. It is unknown whether this will disrupt public unions strength in negotiating but it has the potential to open the discussion on pension and OPEB reform. According to a Bloomberg article, the ruling dealt "a potentially heavy blow to the economic clout of the labor movement through a decision that affects 5 million workers". As an example, the significant union reforms passed in 2011 by the state of Wisconsin ("Act 10") resulted in union membership declining by 36% (13% of the state's population in 2011 versus 8.3% in 2018.)

While we don't anticipate the court's rulings to materially change our view on any issuer's creditworthiness, we view the *Wayfair v. South Dakota* ruling as a credit positive as an opportunity to collect more revenue and the *Janus v. ACFSME* ruling as an opening for states to better negotiate pension talks. We at RSW remain steadfast in our top-down credit approach favoring issuers with diversified revenue streams, unrestricted fund balances and manageable long-term liabilities. We continue to limit our exposure to issuers with high unfunded pension liabilities and significant structural imbalances.

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