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RSW's Q2 2019 Fixed Income Newsletter

"Pressure"

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Under pressure from President Trump to cut interest rates and mounting economic pressure exacerbated by an escalating Trade War, Federal Reserve Chairman Jerome Powell elected to stand pat at the June Federal Open Market Committee (FOMC) meeting.

On second thought...let's back-up…before we get into the weeds, let's go up 50,000 feet to get a better perspective.

After the 2008 debacle, Federal Reserve Chairman Bernanke embarked on an easing campaign that included an arsenal of extraordinary measures. The perpetual policy to maintain a "free money" financial system encouraged market participants to feel invincible. Risk tolerances were expanded and investors ventured into the least liquid, riskiest assets and embraced the longest maturity debt. An environment whereby FOTMBHILOA (Fear of Telling My Better Half I Lost Our Assets) was replaced by FOMO (Fear of Missing Out). This investment mentality became the new normal, as the Federal Reserve maintained a monetary policy that was too loose for too long.

"You May Be Right"

Realizing this, the Fed under Janet Yellen (continued by Chairman Powell) proceeded to tighten monetary policy for three years and hiked short-term rates by approximately 225 basis points (2.25%). As longer-term borrowing costs also surged, we sensed that the economy was beginning to buckle under the weight of bloated debt levels and higher interest rates. Therefore, last summer and into the fall of 2018, we began to lean hard against the consensus view of the pundits and "bond kings" and projected that U.S. Treasury bond yields would begin a meaningful decline.

As highlighted in RSW's Q1 2019 commentary: "despite 10 years having passed since the last recession, across the globe, we remain in the grip of a deflationary quagmire... later this year, we believe this storm should emerge in plain view and show itself in the form of a massive deleveraging cycle." During the second quarter, the dramatic rise in bond prices served to be an acknowledgement of a pending deleveraging cycle. This shift in mentality came even sooner and was more dramatic than even we anticipated.

Furthermore, we certainly didn't suspect that rates would plunge unabated. In fact, from RSW's Q1 2019 commentary we said: "While yields have seemingly declined in a straight line since year-end, the next move cannot be called by using the same ruler. In short, we continue to believe that the potential yield fluctuations ahead should provide a ripe environment for RSW's team to adjust portfolio positioning to capitalize on those opportunities".

From their October 2018 highs of 3.24%, Ten-year U.S. Treasury bond yields collapsed to a June low of 1.98%. With interest rates crashing all along the yield curve, the bond market seems to be agreeing with us, that the Fed has once again "overtightened". Unfortunately, the Federal Reserve's misstep is somewhat predictable. After all, the indicators being relied upon by the Fed are mostly backward looking. Once the economic statistics are released, the data holds limited predictive value to assess the future strength of economic activity and rate of inflation.

It is also important to note that Federal Reserve policy operates with a lag. As the Fed adjusts the level of short-term interest rates, the effects of its changes may not show up in the economic data for 12 to 18 months. Our point here, is that the full effects of the Federal Reserve's tightening campaign has not fully worked its way through the system. With the Fed's last rate hike in December 2018, we believe that the economy is just beginning a lengthier period of contraction. As the year unfolds, we believe the pace of GDP and rate of inflation will decline markedly from the first quarter's pace of 3.1% and 1.6% (Core PCE deflator) respectively.

"Don't Ask Me Why"

Now…Under pressure from President Trump to cut interest rates and mounting economic pressure exacerbated by an escalating Trade War, Federal Reserve Chairman Jerome Powell elected to stand pat at the June Federal Open Market Committee (FOMC) meeting.

This time around the Fed's mistake was not staying loose for too long, but too tight!! Again, the culprit is a reliance upon lagging indicators. As recently as June 25th, at an event at the Council on Foreign Relations in New York, Federal Reserve Chairman Jerome Powell stated that "we will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion". Furthermore, it was added "Solid fundamentals are supporting continued growth and strong job creation, keeping the unemployment rate near historic lows".

Since World War II, the U.S. has experienced 10 recessions and all were likely caused by a Federal Reserve that tightened monetary policy too aggressively. While we are not yet calling for a recession over the next 12 months, we do believe that the Fed did "over-tighten" and that the impact of raising interest rates by 240 basis points since the Great Recession, combined with the negative impact of tariffs on exports and consumption are beginning to emerge.

"Captain Jack"

Therefore, we believe it is only a short period of time before Chairman Powell stops acting like Paul Volker (Federal Reserve Chair from 1979-1987 who brought inflation to its knees by hiking short term rates to 20%) and assumes the role of "Captain Jack" (Pusher…Reference for Billy Joel listeners). It is likely that as the weak economic data rolls in, Chairman Powell will be forced to succumb to the pressure and inject vast sums of liquidity into the arm of the financial system.

This time around, however, the economic push that we will receive from the Fed's stimulus should be met with diminishing returns. We must be mindful that monetary policy is a blunt instrument and a debt problem cannot be cured with higher levels of debt, as this was attempted following the 2008 crisis. Therefore, at today's historically low levels of interest rates, we could be experiencing a real Federal Reserve conundrum. From here, monetary policy may only be effective in one direction; higher rates.

Should interest rates continue their race to zero, with consumer, government and businesses already saddled with vast amounts of debt, it should become even more difficult to entice additional levels of borrowing. Said differently, revisiting the "zero bound" experiment should not produce the same level of "excitement" as the first time the policy was implemented.

As we reflect on history, it becomes painfully obvious that on many occasions the Federal Reserve cures problems -- but in the process tends to create others. We have always believed that the risk of "throwing money from a helicopter" is not inflationary. How can it be when debt levels are extreme and the country faces large demographic challenges? Globally, roughly $12 trillion in outstanding bonds are trading at negative yields as investors are choosing to lock in an investment loss rather than spend or invest today. If inflation is really today's nemesis, then why are negative interest rates failing to reignite the borrowing and spending habits of the "good old days"??? There is clearly something amiss within the economic landscape and the ongoing challenge to generate higher sustainable levels of growth and inflation is likely telling us just that.

"And So It Goes"

Extreme levels of debt, an aging population, combined with record low birth rates are applying downward pressure on the pace of economic activity, inflation and interest rates. As we have asked for nearly a decade: How do you get to lower interest rates? Move to higher interest rates first. This played out with last year's higher rates that's brining us this year's lower rates.

And so it goes... Issuers tend to get overly exuberant and accumulate vast sums of debt at lower interest rates. It is these borrowers however, that will likely feel compelled to slash spending as rates rise and cause their interest expense to become a larger share of the overall budget. Each time this cycle emerges, our nation's economic underpinnings are weakened.

As downward economic activity emerges in plain view, it's now time for the central bankers to look through the windshield and away from watching the lagging indicators in the rear view mirror. This is where we are today. The Fed should soon acknowledge the possibility that the odds of a recession are growing... feeling the "Pressure" to act aggressively and a series of rate cuts shouldn't be far behind.

Municipal Commentary

Investors looking for tax-exempt income continued to pile into the tax-exempt market at a record pace throughout the second quarter of 2019. Roughly $44 billion has been added to municipal funds since the beginning of 2019, a rate that has not been seen since the financial crisis.

The increase in demand for tax-exempt debt coincided with a reduced level of new issue supply. Around the country, governments are showing less interest in borrowing money, having turned more cautious as the prospect of a recession looms. Specifically, a meaningful slowdown in economic activity could resurrect austerity programs that ensued subsequent to the last economic downturn. Furthermore, for issuers interested in refinancing their outstanding debt obligations, time is a factor, as the process is not quick for an issuer to bring a bond issue to market. In fact, many local governments need voter approval to issue debt and state governments are constrained by their budget's timeline.

The strong demand relative to the limited supply described above caused municipal yields to fall at a faster pace than their U.S. Treasury brethren. This can be seen in the relative yield ratio of 10-year "AAA"-rated tax-exempt bonds as a percentage of comparable maturity U.S. Treasury debt as it declined to 70.09% during the second week of May. As the U.S. Treasury Bond market rally continued however, "ratios" rose steadily throughout the balance of the quarter. This occurred as professional municipal bond investors began to balk at the lower yield levels. This reluctance to chase yields lower caused the municipal-to-Treasury ratio to peak at 82%, still significantly below their five-year historical average of 90%.

Late last year, when we surmised that the pessimism toward the bond market hit extreme levels, we extended the duration of our client portfolios. As the bond market rally has unfolded this year and the municipal asset class was valued at the most expensive levels that we have seen in decades, we turned more cautious in our management approach. Specifically, we have elected to allow the duration (measure of interest rate sensitivity) of our client accounts to drift lower with the passage of time. Over complete market cycles, by managing risk and reward with our disciplined process, we should continue to produce strong results versus each strategy's respective peer group.

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