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RSW's Q2 2020 Fixed Income Newsletter

"Flash Point or Turning Point?"

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Flash Back

A quarter has now passed since mass panic and hysteria engulfed our financial system causing it to convulse. It was at that time, where no scenario seemed too unimaginable or negative. The contrast between the mood of investors now and then could not be more disparate as fears of a total collapse of private credit seem like a distant memory today.

Flash Crash

Municipal bonds, the once "boring" asset class, were uncharacteristically volatile throughout this period of global dystopia as price fluctuations were extreme. Late in the first quarter, in response to the economic crisis, Congress passed the $2.2 trillion "CARES" (Coronavirus Aid, Relief, and Economic Security) Act, with $335 billion in relief aimed at municipal issuers. Despite these actions taken by Congress, tax-exempt market prices continued downward during March as many investors feared a historic level of municipal bond defaults. With investors panicking and attempting to squeeze through a relatively narrow window of liquidity, the broker/dealer community became overwhelmed and constrained their ability to provide financial resources.

Against a backdrop of this unprecedented market illiquidity, the bid-to-ask spread, in certain instances, widened from a typical institutional price level of approximately ¼ point (.25%) to 10 points (10%). Mutual fund outflows reached their crescendo during the first week in April, as investors yanked $15 billion out of tax-free bond funds. To put this level of redemption into perspective, this amount was 8.5 times greater than the average weekly inflow recorded during 2019.

Back in a Flash

To squelch the "run on the funds", on April 9, 2020, the Federal Reserve created a Municipal Liquidity Facility that offered up to $500 billion in lending to states, cities, and counties. The announcement of this unprecedented move combined with subsiding fears of a wider virus spread sparked a massive tax-exempt bond market rally that spanned most of the quarter. Having exceeded our most optimistic scenario, market yields on some issuers and maturity points are back to pre-pandemic levels.

While municipal bond prices have experienced a "V" shaped recovery, the economic data and/or creditworthiness of bond issuers has yet to normalize. This divergence leads us to believe that investors are now willing to pre-pay for a positive outcome. Unlike other shocks to trade and industry, the Covid-19 episode should continue to cause massive disruptions to the Global economy that will be felt for years to come. Some prognosticators are justifying the rebound in the markets with their forecast for considerably stronger economic activity. We, on the other hand, believe reasonable skepticism is warranted. Putting aside the pandemic related challenges to revitalizing our nation's growth rate, the economic system already suffers

from severe pre-existing conditions.

While many in the media attribute the pandemic to be the “cause” of the nation’s economic problems, we do not believe that to be the case. To us at RSW, the spark was Covid-19, but the kindling was a pile of debt that served as the conductor for the timber of aging demographics and already slowing economic activity. These dynamics led us to conclude that this year would usher in a massive deleveraging cycle (debt restructuring, deflation etc.). To that end, in RSW’s 2020 Outlook we said, “we believe that the recent optimism is misplaced and that a financial event could be unfolding”.

Flash Response

True to form, Federal Reserve Chairmen Powell brushed off his crisis playbook to stave off a “Modern Day Depression”. His actions included slashing short-term rates to near zero and creating an alphabet soup of lending programs totaling more than $6 trillion. Specifically, the Fed announced its intentions to purchase corporate bonds, municipal bonds, and virtually any securities that were “credit related”. This bold and unprecedented maneuver provided a “wall of liquidity” that buoyed investor confidence and served to lift asset prices. With that said, in the category of there is no such thing as a “free lunch,” we must examine the downside of these measures.

While the Fed has the power to levitate assets prices, they lack the ability to forge earnings, or in the case of municipal bonds, tax revenues. Akin to 2008, by rewarding those companies or municipalities who made poor decisions, the entire notion of a meritocracy is flipped on its head. After all, what keeps the system operating somewhat efficiently is that those with a profit motive make sound decisions and those who have no tolerance to lose money compel the decision makers to act responsibility. Is this what is happening now?

Against a backdrop of near-zero percent short-term interest rates and belief that the Fed has your back, investors have become more willing lenders to riskier borrowers, despite the lower yield levels. On the flipside, the Fed’s low interest rate policy and implicit bailout guarantee has enabled corporations to access the debt markets as their ability to borrow expanded. With 33+ million unemployed or underemployed and free cash flow drying-up, companies are busily ramping up their level of indebtedness. In fact, since the beginning of the year, corporate borrowings have topped $1 trillion, roughly double last year’s pace.

We must be mindful, however, that it is the nation’s reliance on debt that has fueled this current predicament. Specifically, low rates have caused several issues. This money for nothing atmosphere has encouraged excessive risk taking, caused banking issues, bloated debt levels, and has exacerbated our nation’s pension crisis.

Conclusion

While we anticipated a rebound in tax-exempt bond prices from the "March Madness", we underestimated the scope and dimension of the rise. Budgetary pressures on municipal issuers remains ongoing and we refuse to cave to the FOMO (fear of missing out) crowd or the Fed by "going for broke". As such we will continue to invest utilizing a conservative and disciplined fundamental approach, not on the reliance of a Fed who says they have our back.

Furthermore, as always, our investment philosophy does not rely on a benchmark to dictate what prudent risk positioning is reasonable for our client accounts. A benchmark does not tell you that the yield curve is historically flat, that we as a nation are falling deeper into dystopia, or that yield levels are approaching the zero bound. While fundamental research must always be embraced, we must also adhere to the time- tested principle of common sense. Should we lend money to the city of Chicago or the state of Illinois on a General Obligation (GO) basis because it is in RSW's index? Likewise, should we lend money to the City of New York? Or how about lower-rated bonds and health care debt just because these securities happen to be in RSW's stated benchmark? We think not! As active managers, there are those times when we must apply the brake pedal firmly and adhere to a "do no harm philosophy".

To summarize: Irrespective of the actions taken in Washington DC and the market's ensuing reaction, we believe that the environment will be choppy. While Jerome Powell may act like Flash Gordon and attempt to save the earth from "extraterrestrial threats", we believe further deterioration in many jurisdictions are likely. A pension crisis, persistent joblessness, reliance on fiscal stimulus, the likelihood of a tax revolt, revenue shortfalls and growing expenditures will continue to provide fiscal challenges as we move forward.

Therefore, while we believe there are likely to be many opportunities to reposition our portfolios over the next 6 months to enhance returns, we are continuing to maintain a defensive posture for our client accounts. Flash Point or Turning Point…Stay tuned.

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