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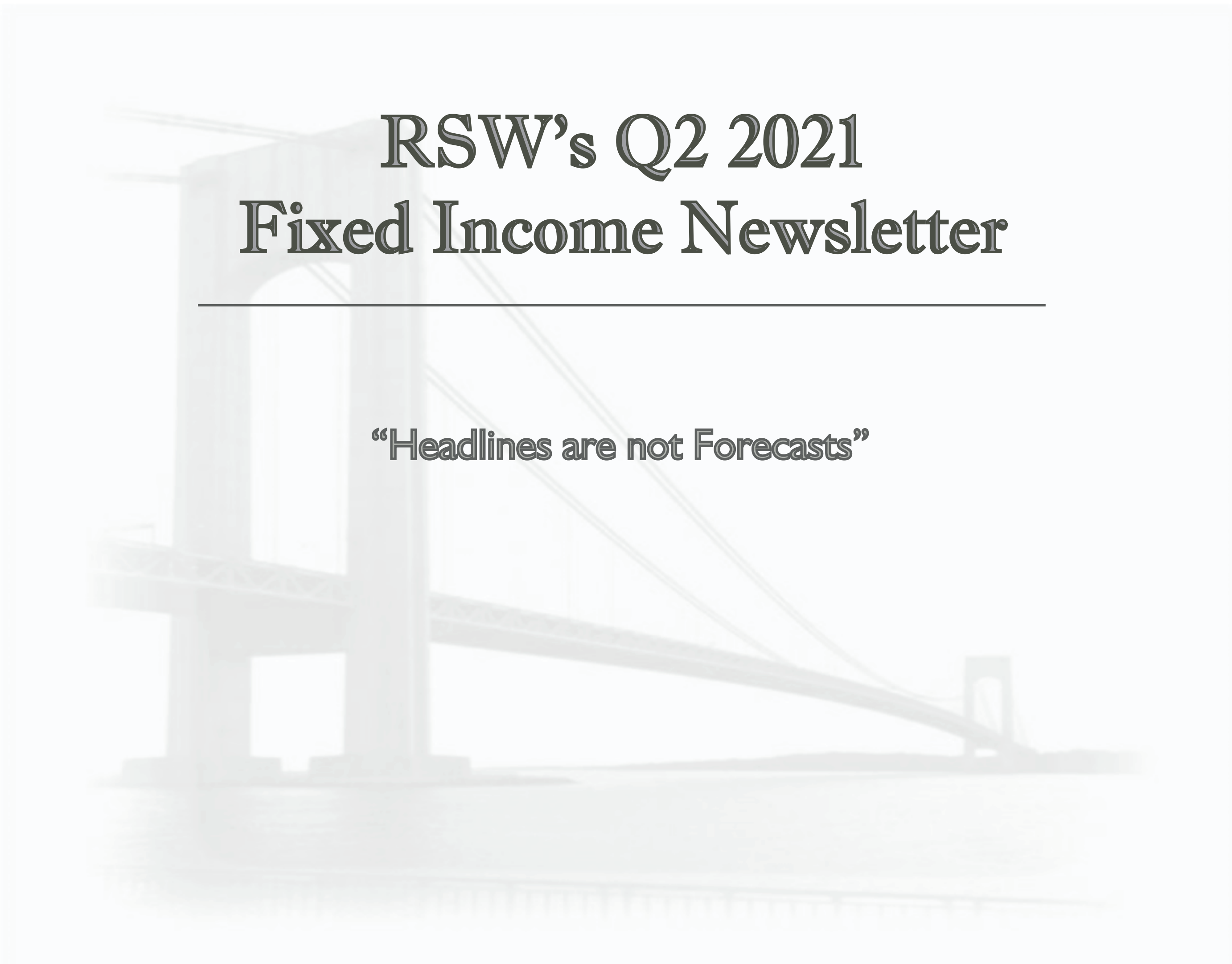

RSW's Q2 2021 Fixed Income Newsletter

"Headlines are not Forecasts"

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“Headlines are not Forecasts”

In the first quarter, the 10-year U.S. Treasury bond yield reached RSW’s projected 2021 Outlook target level of 1.75%. That yield surge, which peaked in March, was fueled by extraordinary Coronavirus stimulus measures, the reopening of the economy and an accommodative Federal Reserve, led by Chairman Jerome Powell.

Headlines such as these captured the mood:

“Powell Expects Bump in Inflation, Says It Won’t Get Out of Hand”- (source: Bloomberg)

“Powell Says Stimulus Package Unlikely to Fuel Undesirable Inflation” – (source: Morningstar)

“Inflation – not virus – now tops investor concerns – survey” – (source: Pension and Investments)

In contrast, the second quarter was dominated by a torrid pace of consumer price inflation which grabbed considerable attention. The fear can be captured by this collection of headlines:

“U.S. Inflation Is Highest in 13 Years as Prices Surge 5%” – (source: Wall Street Journal)

“Rent for single family homes soared to a 14-year high as the housing boom escalated in March” – (source: Business Insider)

“Americans’ inflation fears reach a fever pitch as consumer prices rise” – (source: CNBC)

While Headlines Drive Today’s Story, the Headlines Yet to Be Written Are the Most Important.

What was the genesis of this inflationary shock? Headlines aside, lets gain perspective by revisiting the past and roll forward.

The damage created by the Pandemic created conditions where demand fell faster than supply which predictably caused prices for goods to decline rapidly. Today’s environment is now the mirror image. The reopening of the economy, easy monetary policies, and massive stimulus bills have provided a backdrop for demand to come roaring back. At the same time, improvement in the supply chain side, while having expanded, has lagged. So, with too much demand chasing too few goods, inflation was once again re-ignited.

Furthermore, when the pandemic hit, many of the low-cost manufacturers and ports in Asia were "on lockdown" and therefore unable to ship their goods into the United States. These forces created an opportunity for the higher cost U.S. manufacturers to gain market share. Now as the ports are re-opening, competition is poised to increase as lower cost goods will be flooding in from overseas, thus capping the price demanded by domestic manufacturers. The bond market is certainly latching on to this theory.

During the second quarter, market interest rates regained their footing as yields trended lower as investors assigned a greater likelihood that this year's rise in inflation may have already peaked. In other words, bond market participants are agreeing with Federal Reserve Chairman Powell that the inflationary surge is "transitory".

Building on this thesis, as we have commented in prior musings, there is a strong case to be made that the "sugar rush" created by the policies in Washington have borrowed growth from the future to create today's economic strength. Since the start of the pandemic, growth was ramped-up with the Fed's balance sheet roughly doubling in size to over $8 trillion. It is also notable that their roughly $4 trillion of U.S. Treasury and Mortgage bond purchases (aka Quantitative Easing; "QE") occurred in addition to policy makers approving over $5 trillion of COVID relief stimulus.

Aside from the unspent stimulus monies that have not yet been injected into the economy, there are additional underlying conditions that may prevent a more benign rate of inflation from materializing "today". In RSW's Q1 Commentary, we posed the question: **Is the Coast Clear?** "While we projected a 90% increase in the yield of the 10-Year U.S. Treasury bond and our target of 1.75% has been reached, we are not ready to release our defensive portfolio positioning". Although the bond market has become complacent that the worst of the Headline News is in the rear-view mirror, we remain ever vigilant.

So, is another leg-up in bond yields possible, before declining into year end? Yes! Although we have not abandoned our deflation call for later this year, followed by declining interest rates, there are several reasons why we are skeptical that we have seen the yield highs for the year.

Combination of Circumstances to Inspire Future Headlines

According to the National Federation of Independent Business (NFIB):

The safety net of Covid related federal unemployment benefits expire in another two months. Although half of U.S. states have opted out early, the June employment report was compiled too early to reflect the millions of Americans who will be scrambling to replace that income.

- 46% of small business owners reported job openings they could not fill in the current period. This is close to the highest for the survey, which originated in 1975. (source: JOLTS report)

- With the proportion of workers leaving their current job to move to a new one hitting a new all-time high, "Owners are offering higher wages to try to remedy the labor shortage problem" (NFIB Chief Economist Bill Dunkelberg.)

- A survey released in June indicated that 40% of small businesses plan to raise their selling prices over the next three months. This is the highest reading since 1981. (source: JOLTS report)

- Fannie Mae is estimating that by the end of 2022, the cost of shelter (rent) single handedly will cause the Federal Reserve's preferred inflation gauge (Core PCE) to rise by an additional 1% by the end of 2022. Since a portion of the Core PCE captures the rents that tenants are currently paying and not today's higher asking prices, the rate of inflation will jump as leases roll off and a new one is inked.

- As of this writing, the Goldman Sachs Commodity Index (index tracks commodity futures of 24 commodities from all commodity sectors from metals to livestock) continues to make new highs and is up around 33% for the year.

They Who Make the Rules Control the Game

In August 2020, the Federal Reserve had taken the necessary precautions to pre-empt the markets from becoming anxious about soaring inflation. To this end, Chairman Jerome Powell called for a "robust updating", whereby rather than focusing on monthly inflation data, the Fed will focus on "average inflation targeting. With thirty-year U.S. Treasury bond yields having declined from March's high of 2.50% to today's 1.94%, it is apparent that the bond market is growing more comfortable with the Fed's transitory argument.

However, with the latest reading of inflation (core PCE) standing at 3.40%, significantly higher than the Fed's old threshold rate of 2%, some Federal Reserve officials seem to be less complacent than bond investors. In fact, Chairman Powell and colleagues have begun their debate as to when the appropriate time is to tighten liquidity conditions in the financial system. Rather than hike short term interest rates, it is likely that the Federal Reserve will first opt to slow or "taper" their purchases of U.S. Treasury and mortgage securities. Essentially, this should have the effect of tightening liquidity conditions and thus drive yields on longer-maturity bonds higher.

We believe a few more months of strong growth and inflation data (our base case), coupled with continuing improvement in employment, will prompt Powell to formally announce a plan to "taper". As you may recall, upon former Chairman Bernanke's announcement of such a plan, bond yields initially spiked higher. Given the unprecedented size of the Fed's balance sheet and overall level of monetary support, a shift in the status quo could spark greater levels of volatility than market participants expect.

With the above being said, we are not prognosticating that the pace of inflation will continue to gather momentum over the longer-term. Just that over the near term, we believe as we did in RSW's Q1 Outlook, that the rise in inflation is not yet behind us. Quite often the economy does not go from humming along to treading water without a catalyst. With history as a guidepost, higher rates usually provide the spark for unpleasant outcomes. Over the near term, these higher rates could be borne from investors or the Fed becoming less complacent with the incoming data.

As far as the Fed is concerned, as we have said many times, the record books are thin with pages where the Fed does things just right. In fact, occurrences of "over-easing" and "over-tightening" by the Fed are often the precursor to economic and financial shocks. At RSW, what is important is not the next Headline that becomes the source of the next opportunity, just that we are prepared for the most likely scenario.

Municipal Commentary

Investor appetite for municipal bonds shattered records this year driven by fears that tax rates could rise. Through May 31, inflows into municipal bond funds topped $50 billion (source: Morningstar) , double the pace allocated for all of 2020. Despite the elevated level of new issue municipal bond supply, the amount of demand served to dampen the interest rate volatility which afforded investors a relatively smooth option compared to other domestic fixed income alternatives.

The improving credit quality of municipal issuers further drove investor demand. Many state and local governments have recovered rapidly from the economic dislocation caused by the pandemic. Specifically, improving tax receipts and Congressional stimulus aid have bolstered the balance sheets of municipalities and revenue bond issuers.

According to Reuters, since March 2020, six separate bills were passed totaling over $5 trillion. The American Rescue Plan Act, inked in March 2021 brings another $193.5 billion into state coffers with minimal restrictions as to usage. In addition, $130 billion is allocated to local governments. All of this is great news for the financial health of most municipal issuers, however, over the long-term credit weaknesses may persist. Much will depend on the effectiveness of managing these financial windfalls.

For example, in the state of New Jersey several tax hikes have already been implemented which could further drive the number of high-income earners out of the state. Namely, the top tax rate has been raised to 10.75% from 8.97% on individuals earning between $1 million and $5 million, the gas tax has been increased by 9.3 cents per gallon, and a corporate tax surcharge of 2.50% has been installed. Lastly, the spending in the state has not been reigned in as Governor Murphy recently passed an historic $46 billion in spending. This exceeds 2019's level by 20%.

With municipal bond yields already reflecting the strong credit fundamentals and the prospect for higher tax rates, we will remain defensively positioned. Especially given our prospect for rising bond yields over the near term. As always, we look forward to the next opportunity to keep you informed.

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