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RSW's Q2 2022 Fixed Income Newsletter

"Law of Holes"

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In 1911, the Washington Post published the following adage in an article: “Nor would a wise man, seeing that he was in a hole, go to work and blindly dig it deeper”. Since that time, this axiom named the “Law of Holes” has morphed into: “If you find yourself in a hole stop digging.”

Should you find yourself in this self-inflicted predicament, it still may be possible to climb out of the hole. There are however, two elementary prerequisites to achieve this desired outcome. First, you must be able to recognize that you did in fact dig a hole and secondly that you have the good sense to stop the excavation.

With the history books filled with pages of the Federal Reserve’s failed endeavors and wild adventures, it is plainly obvious that this collection of wizards is not familiar with the Law of Holes.

As a refresher, at the beginning of the pandemic in February 2020, the Fed’s balance sheet stood at $4.2 trillion (Source: Federal Reserve). After 26 months of continuously purchasing U.S. Treasury and Mortgage-backed securities to drive down longer-term interest rates, the Fed’s balance sheet ballooned to $8.9 trillion (Source: Federal Reserve). To put this $4.7 trillion balance sheet expansion into context, the entire QE program during the 2008 financial crisis amounted to $3.6 trillion.

Over the years, Federal Reserve policies have utilized a three-pronged strategy. Namely: “Over-Ease”, “Over-Tighten”, and “Repeat”. What does this mean for bond market investors today? Judging from the data contained herein, experience and historical context, at RSW we firmly believe that the Fed has already “overtightened” monetary conditions. Therefore, our base case is that by year-end, longer-maturity bond yields will fall precipitously. In fact, by the end of the year, our base case calls for Chairman Powell to reverse course and start to lower the Federal Funds Target Rate. Why will this happen? Please read on.

Over-Ease

Since the beginning of the pandemic, trillions in stimulus payments combined with overly easy monetary policies created huge waves of liquidity that propelled asset prices and broad-based inflation parabolically higher. Forecasting this occurrence, in RSW’s 2021 Outlook we wrote: “Over the coming months, do any of the government policies seem like they won’t lead to stronger economic activity, greater levels of inflation and higher long-term bond yields?” Additionally, “we believe that the likely outcome of the ‘More-On’ strategy should amount to a ‘sugar rush’ and not a sustainable up-tick in economic growth.”

Overtighten

Now that the shovel loads of cash have been digested into the system and converted into “economic energy”, the financial benefits are fading quickly. We forecasted this occurrence in RSW’s 2022 Outlook by stating “economic growth to turn negative in the second half of the year…A Fed misstep should only hasten this outcome…as they overreact to yesterday news by ‘slamming on the monetary brakes’.”

What’s being shoveled?

Recently, Federal Reserve Chair Jerome Powell said the US economy is in “strong shape” and that “recession likelihood is not elevated”. As you probably have already guessed, we fiercely disagree. With consumer spending representing

approximately 70% of our nation's GDP, a key to forecasting the pace of future economic activity lies in correctly assessing our citizens ability to consume. Against a growing list of challenges that include soaring inflation, negative real earnings (after inflation), food insecurity, rising interest rates, loss of confidence in the Fed, and a war in Ukraine, we believe a massive slowdown in consumer spending lies ahead.

As of this writing, forecasts for a recession are now becoming mainstream amidst mounting evidence that economic activity has indeed stalled. Supporting data:

- Q1 GDP was reported at (-1.50%) with Q2 expected to be (-1%) (Source: Atlanta Fed GDP Now)
- Consumer Sentiment Index has fallen to record lows (Source: Bloomberg).
- Personal Savings Rate has fallen near the lowest levels recorded since 1959 (Source: FRED).
- The pace of consumer credit has exploded (Source: FRED). With personal savings being exhausted many are turning to credit cards to pay living expenses.
- Each month since April 2021, wages have fallen short of the Consumer Price Index. In fact, if you were to sum the monthly figures, the cumulative amount would equal (-26.7%). To put this figure into context, the last time inflation outpaced wages was during the "Great Recession" where the cumulative negative monthly earnings totaled (-16.8%).
- The single-family housing market is "rolling over" as dwellings approach levels that are the least affordable in history. Over the past ten years or so, the median home price in the United States rose by around 30%. However, during that same period, incomes have risen by just 11% (Source: NAHB).
- The yield differential between the least and most credit worthy borrowers is widening in the corporate bond market as lenders demand greater levels of interest rate compensation to extend loans to "riskier" borrowers.

If you were an investor who just returned from a deserted island and observed only the data above, you would wager a small fortune that the Federal Reserve was aggressively slashing short-term interest rates.

So, against a backdrop of faltering growth and a consumer that is likely tapped out, the Fed, with their shovel in hand, continue unabated with their plan to continuously hike rates. We need to look no further than some of their recent communications to judge their resolve:

- "Fed promises unconditional approach to taking down inflation."
- Powell told the Senate that managing a soft economic landing will be "very challenging."
- Powell said the Fed's interest rate increases are "designed to drive growth down to a level that is more sustainable."
- "We can't fail on this; we really have to get inflation down to 2%."

Why is Chairman Powell so "Shovel Ready"?

Simply put, the Fed is scrambling to correct an epic policy mistake. They failed to raise rates at a time when inflation wasn't transitory but was broad-based, persistent, and buoyed by wage pressures driven by a scarcity of labor.

One way to frame how loose monetary policy remains is to examine the real yield (after-inflation) of one-year U.S. Treasury Bills. With one-year T-Bills yielding 2.86% and the Consumer Price Index (CPI) at 8.58%, the real yield is (-5.72%). Putting this into perspective, to find such a negative real yield we would need to go back to 1951 (long term trends). In fact, only on two other occasions in the last 100 years has the Fed allowed the "real rate" to fall this low. Think about it, the real

rate today is lower than the uber policy accommodation after the 1987 crash, the dot com bubble, and the 2008 global financial crisis.

Here's Where the Shovel Meets the Dirt

If monetary policy is still perceived to be loose, can the Fed continue to hike rates at a robotic pace?

While all attention is focused on the Fed rate hikes, we must be mindful that in March of this year the Fed concluded their QE program. Annually, roughly one trillion dollars in U.S. Treasury and mortgage-backed bonds were purchased and added to the Fed's balance sheet. Now, without that persistent wave of liquidity the economy must function on its own, devoid of intervention.

Further growth headwinds should emerge as the Fed is scheduled to reduce the size of its Treasury debt holdings under their Quantitative Tightening policy (QT). Specifically, the Fed is actively decreasing the size of its U.S. Treasury holdings by $30 billion and its mortgage-backed securities (MBS) holdings by $17.5 billion monthly, with plans to double those monthly cuts starting in September. Estimates are all over the map as to the monetary tightening impact of the cancellation of QE and ramp up of QT, but we strongly believe the economic impact will be substantial.

Against a backdrop of evaporating pools of government liquidity, the table is set for troubling economic and financial outcomes to emerge. While the environment over the last several months has been challenging, we believe it only offers a taste of some events in the back half of the year. Despite negative real rates, in our opinion the Fed has already overtightened, and the full impact of their work has yet to be witnessed.

Repeat

With history as our guidepost and as we have said during the last rate hike cycles, the Fed will only conclude their plan of tightening monetary policy after they "break something." Our base case is that the Fed's anxiety about rampant inflation gives way to concern over the economy, the price of risk assets and/or the health of the financial system. To that end, before year-end we believe the Fed pauses or begins to reverse course by cutting rates. As is typical, long term bond yields should fall dramatically (prices rise) in anticipation of these events and persist during such developments.

The table is now set for RSW to issue its fourth "Strong Buy" opportunity. This is only the fourth such "bullish" recommendation in our firms' 17-year history, with the prior pronouncements being 2008, 2010's Meredith Whitney debacle, and the 2018 interest rate surge.

Municipal Bonds

Prices remained under extreme pressure during the second quarter as the direction of tax-exempt yields took their cue from the U.S. Treasury bond market. For the period the broad market as measured by the Bloomberg Municipal Bond Index was down (-2.94%).

As you may recall, the first quarter was marked by near record waves of municipal bond mutual fund redemptions. As individuals redeemed fund shares, the marketplace became saturated with bonds as portfolio managers sold bonds to meet shareholder redemptions. This caused the upward surge in tax-exempt yields to exceed those in the Treasury bond market.

The reverse was true in the second quarter as a semblance of balance between buyers and sellers emerged. This allowed the ratio of ten-year maturity "AAA"-rated bond yields as a percent of comparable maturity U.S. Treasury bonds to fall from the May peak of 105% to 91%.

In terms of credit quality, the market broadly speaking is in solid position. General fund revenue collections across the states are strong, reflecting better-than-expected tax receipts and continued federal monetary support.

As we approach the end of fiscal year 2022, most states expect to have collected the largest fiscal cushion on record. At the same time, improved economic and financial conditions have enabled local governments to benefit from stabilized intergovernmental aid and local tax revenues.

Over the near-term, however, we believe the economic environment should remain challenging over the next year. Therefore, we remain cautious and highly vigilant with respect to credit risk, as a sustained economic downturn should put some downward pressure on state and local government budgets and unfunded public pension obligations. However, the financial cushion mentioned above should provide a buffer against credit rating downgrades in this challenging environment.

In concert with our view that the economy is too fragile to withstand elongated periods of elevated rates, we continued to extend the interest rate sensitivity (as measured by duration) of our client accounts to more neutral levels relative to our benchmarks. While another upward yield shock is possible, we believe these higher yields will give way too much lower levels by year-end. To that end, we remain focused on enhancing the average maturity and durations to "lock-in" today's higher yields and be better positioned to capitalize on the significant price appreciation that we believe lies ahead.

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