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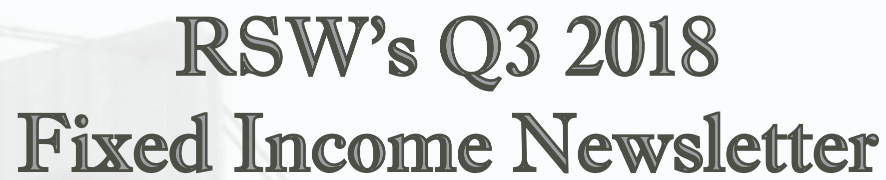

Will Premise "Yield" to Price

RSW Investments, LLC ▪ 47 Maple Street, Suite 304 ▪ Summit, NJ 07901-3647 ▪ (908) 608-9600
www.rswinvestments.com

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Preamble

At RSW, we have always put a premium on communication, whether the topic was unpleasant or calming. Our goal is to "call them as we see them", in a manner which reflects a view that does not believe the "end is near", nor reflects the belief that Central Banks can save the world.

Review

On May 16, 2018, when 10-year U.S. Treasury Bond yields reached 3.10%, we communicated our belief that an opportunity was forming in longer-maturity bonds. While that elevated yield level remained impenetrable for nearly five months, our target was breached on Wednesday. Stronger than anticipated U.S. economic growth, surging consumer confidence, a rising "headline" rate of inflation (driven by higher oil prices) and a Fed committed to hiking short term interest rates have caused U.S. Treasury and tax-exempt bond yields to spike higher.

With the rate of inflation on the move, the Federal Reserve now feels even more emboldened to raise rates. Specifically, the "Core Personal Consumption Expenditure Index "(Fed's preferred measurement of inflation) recently posted a reading of 2.10% and is now above the Fed's threshold target rate of 2%. Historically, however, the Fed models have proven to be useless as the rate of inflation has shown itself to be a lagging, not a leading indicator.

Furthermore, when the Federal Reserve tightens monetary policy as inflation moves above their target, it is not long before they find out that they actually "overtightened". Quite often, policy makers then scramble to slash rates as a recession ensues and inflation sinks. To this end, the nation has endured nine Federal Reserve tightening cycles in the past four decades. The Fed has inverted the yield curve on six of those occasions, and out of those six rate-hike induced inversions, the economy has skidded into a recession one year later all six times.

Ahead: Domestic

While our Yield (Price) target was breached, we believe our deflationary premise continues to hold true. Specifically, we have maintained a long-held belief that because of our nation's bloated debt levels, interest rates need not move to historic norms before they meaningfully impair economic activity and financial assets. In fact, we are already seeing the evidence of the headwinds caused by rising interest rates.

A combination of elevated home prices in many markets and rising rates have caused the Housing Affordability Index to decline to levels not seen since Q3 2008. In fact, over the last twelve months, sales of existing home sales are down 1.50% and mortgage applications have fallen at a double-digit pace. A declining personal savings rate is exacerbating these trends as the personal saving rate has been in decline and is now approaching levels not seen since its pre-2008 levels.

As you may recall when the Fed embarked on a Quantitative Easing (QE) policy, the Fed acquired roughly $4 trillion in market value of Mortgage and Treasury securities. As these securities matured the Federal Reserve reinvested the proceeds to purchase additional bonds. However, in late 2017, the Fed slowed the amount of additional Treasury and Mortgage bond acquisitions in a reversal of its QE strategy known as QT (Quantitative Tightening). The Fed is now on track to purchase $600 billion fewer bonds per year, thereby increasing the supply of bonds in the marketplace. The higher rates caused by this policy, should serve to wield additional deflationary pressures on the US economy, with huge potential implications for global financial markets and the world economy.

Ahead: Global

The U.S. dollar is still the world's reserve currency and its liquidity is therefore of tantamount importance. When the availability of U.S. dollars is abundant in the financial system, the dollar is normally weak, global trade tends to be strong, and commodity prices rise. However, when dollar liquidity tightens, these gears tend to get thrown into reverse.

Global Central Banks, led by the Federal Reserve, are busily reigning in monetary policy. The pace of global QE is cratering as asset purchases by the Fed, ECB (European Central Bank) and BOJ (Bank of Japan) are scheduled to fall to Zero at the end of 2018 from 2017's monthly pace of $180 billion. Simply put, globally, an additional $70 trillion (approximately a 40% increase) of global debt has been issued since 2007. With central banks in the process of withdrawing the "punchbowl" of liquidity, rates could be pressured upward. In fact, at RSW, we believe that the Fed has already boosted rates too high and that these elevated yields are causing meaningful dislocations in many countries.

The “global suffering” inflicted by a strong U.S. dollar is already apparent in the performance of emerging market economies, their currencies and stock market returns (Please refer to RSW’s Q2 2018 Quarterly Report for more detail). So, why does a municipal bond investment manager care about emerging market countries? If anyone doubted the level to which the world economies are interconnected, they weren’t managing money or paying attention during the 1997 “Russian Default Crisis” or the 2008 “Great Recession”.

By hiking rates robotically, it appears that the Fed is only targeting the strength of our nation’s economy, while ignoring the pace of global tightening. As long as our policy makers continue to view the world one-dimensionally, the non-US world runs the risk of a substantial economic contraction. We also must be mindful that 10-year Treasury yields serve as an indicator of a global benchmark for funding costs. Sharp movements in its yield can send tremors that cuts across all rates and bond markets, including corporate and emerging market securities. A global economic contraction caused by elevated rates has in the past and could again boomerang back to the U.S.

What does all of this mean to me?

- ✓ Rising tax-exempt yields have put downward pressure on the performance of all high quality bond portfolios, including those that are “buy and hold”.

- ✓ We are patiently awaiting an opportunity to extend the interest rate sensitivity of our client portfolios. This portfolio shift should afford us with an opportunity to maximize the potential for price appreciation and enhance income.

- ✓ Yields on cash are temporary! Not permanent! When it becomes apparent that the Fed has made a policy mistake they will most likely reverse policy quickly by slashing rates. We know with the benefit of hindsight that these events unfold rapidly and timing them could serve to be a futile effort. If cash positions are built, long rates can shift rapidly and the opportunity to lock in higher yield levels can be lost.

- ✓ There is a chasm of difference between investing and trading. As professional money managers we do not invest by seeking to pile in to the best performers and robotically discard under-performers. Likewise, Financial Advisors, working with their clients also seek to take the emotion out of investing and adopt a strategic vision with realistic goals.

Year-to-date, the duration (measure of interest rate risk) of our client portfolios has remained dialed-in to the lower end of our firm's historical levels. Our core discipline targets premium coupon callable bonds as protection against rising market yields. In addition, recently, we have actively employed a strategy of allowing our holdings to age ("roll") for a longer period of time than is typical before rebalancing portfolio risk characteristics (extending duration, maturity, etc.). This strategy has served to further diminish each portfolio's level of price volatility and has been purposefully incorporated into our investment process as a "hedge" against the current environment so that, over time, we can begin to opportunistically take advantage of higher market yield levels.

While RSW's investment philosophy emphasizes total return, this does not come at the expense of generating tax free income and capital preservation. "Making money" on a bond portfolio does not compete with the potential for making money from equity allocations nor is the potential for a negative return remotely comparable. An allocation to the municipal bond market does however provide a steady stream of tax-advantage income and enhances portfolio diversification.

Robert S. Waas Chief Executive Officer / Chief Investment Officer	Matthew T. Werner Senior Portfolio Manager	Mark J. Tenenhaus Director of Municipal Research	Mark A. Scott Senior Trader	Randy J. Fox Assistant Portfolio Manager	Andrew C. DeVivio Junior Credit Analyst	Alec K. DeWitt Product Specialist	Marites V. Pasturan Compliance Officer	Jeffrey S. Thompson Client Service Associate	James D. Thompson Client Service Associate	Mary Chris Ong Trade Operations Associate

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