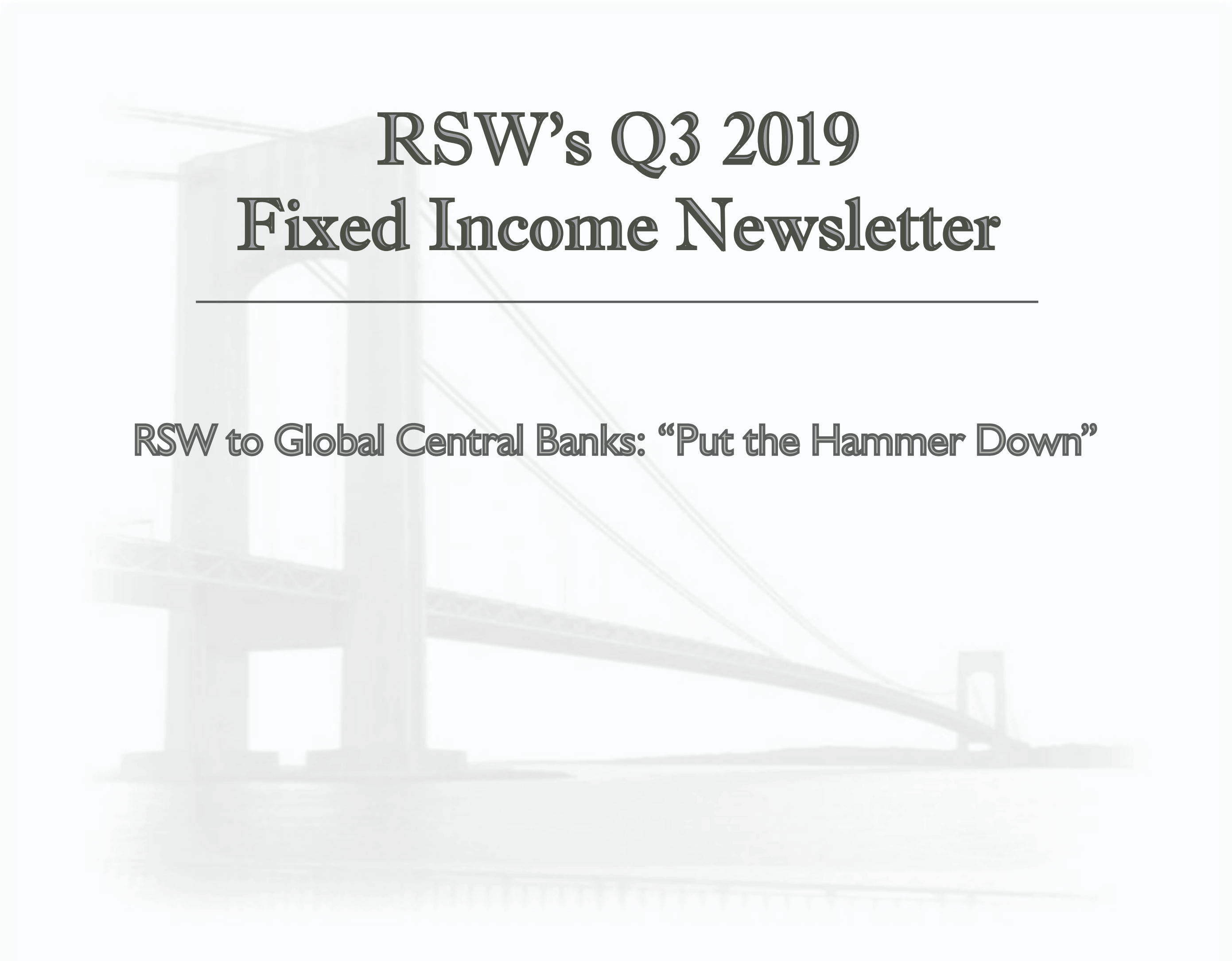
October 3rd, 2019



RSW's Q3 2019 Fixed Income Newsletter

RSW to Global Central Banks: "Put the Hammer Down"

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RSW To Global Central Bankers: "Put the Hammer Down"

Since it was first published in 1983 by Frank J. Fabozzi, *The Handbook of Fixed Income Securities* has been the "bible" for us bond geeks. The book covers virtually all aspects of fixed income investing from Credit Linked Notes, to Collateralized Debt Obligations, to High Yield portfolio management techniques and yes, Municipal Bonds. In its pages, we were also taught an unshakable truth. Namely, the yield on fixed income securities can never fall below zero. Well, welcome to the upside down, where truths have been downgraded to merely concepts. Welcome to the upside down where the track records of some long-term veterans, former "bond kings" and even the reputations of Federal Reserve Board Chairman may have been reduced to rubble. It seems that even a book that is still heralded as the "gold standard" may need a rewrite.

Upside Down and Inside Out

The third quarter ushered in some firsts, as rates on the entire German yield curve collapsed into negative territory and approximately $16 trillion of outstanding global debt likewise carried negative yields. That's right, lenders of money are accepting a zero-coupon rate and willingly handing over more than 100 cents on the dollar to the borrower. Having been stuck in a deflationary environment for decades, bonds issued in Japan account for roughly 40% of the world's negative yielding debt. To be sure that ample demand exists for this losing investment, the Japanese Central Bank purchases almost all their government's debt. Here at home, as partly a reflection of this global bond lunacy, the yield on 30-Year U.S. Treasury Bonds fell below 2% for the first time in our nation's history.

During the third quarter, we also witnessed the yield on 2-Year U.S Treasury Notes surpassing those offered on 10-year maturity debt. This phenomenon, known as an inverted yield curve, hasn't occurred since 2007 and drew a lot of media attention. While sometimes sending a false signal that a recession was imminent, an inverted yield curve has, in fact, preceded every U.S. recession in modern history. It was the fear of a recession that seemed to force the hand of Federal Reserve Chairman Powell to cut the level of short-term rates twice by one-quarter point (total of 50 basis points) during the period. As you may recall, this was in sharp contrast to the Chairman's steadfast position that he held in June of this year, when he stated that a rate cut was not necessary or imminent.

As we have written on many occasions, a rapidly aging global population (demographics) lies at the heart of the global economic slowdown. According to The Wall Street Journal, the trend of declining birth rates is continuing across the globe. The Japanese government recently reported the lowest number of births since 1899, while in the United States, our birth rate has skidded to the lowest level in 32 years.

The reality is that economic activity flourishes through population growth and innovation. As populations age, the demand for income generating assets increases and the pace of spending decreases. Lower levels of consumption coupled with escalating costs to care for an aging populace create an impenetrable barrier to "normalizing" a nations growth potential. Some governments understand where the cracks lie in their economic foundation and are applying mortar to prevent the fissures from spreading. To this end, some European countries are paying couples to have babies and China is exploring the same policy.

"If All You Have is a Hammer, Everything Looks Like a Nail"

Against a backdrop of weakening economic activity, Central Banks have continued with their monetary "Science Fair Projects". The European Central Bank, Bank of Japan, and Central Bank of Sweden have pushed their short-term interest rates into negative territory. These Central Bank gurus believe that negative interest rates will spark an economic resurgence as individuals flee high quality low or negative yielding assets and spend or invest in riskier endeavors. Time and time again however, the results do not support their desires and beliefs. To prove this point, we need to look no further than Japan, where deflation has reigned for decades. Negative interest rates and one quadrillion yen in indebtedness, totaling 235% of GDP, have been no match for the deflationary headwinds caused by an aging society.

At RSW, we strongly believe that negative interest rate policy implemented for prolonged periods of time transforms the policy from a panacea to the disease.

Specifically:

- In Europe there are companies whose debt is rated "BB" or below (aka junk), that is trading with negative yields. Although these companies are being propped-up by getting paid to borrow money, it does not mean that they can ever become dynamic businesses. When corporations stay afloat as "zombie companies" (overly indebted), individuals may remain employed, but the innovation may have died as funds to invest for the future were depleted. Relying on debt relief through negative borrowing costs does not and cannot encourage innovation, it just prolongs the time a company can survive.

- Negative interest rates serve to scare the populace as they view this event as a sign that something is very wrong. While fundamental economic statistics may still be considered by the public, negative rates serve to sum-up the economic quagmire, which erodes confidence and squelches the level of investment and consumer spending.

- Pension funds invest a meaningful portion of their assets in fixed income securities. Investing in bonds carrying negative yields jeopardizes the financial security of the current and future retirees. To ensure enough liquidity in the retirement pool, corporations may have to increase their level of contributions, which detracts from their ability to consume or invest in the future.

- Insurance companies likewise feel the pinch as they invest a considerable portion of its funds in fixed income securities. Those operating in this industry attempt to earn a “spread” between the money that can be earned on bonds and the future payouts of its insurance policies. To minimize the damage inflicted by negative rates, these entities may invest in riskier assets to generate the necessary return.

- Negative rates clobber savers who lose money on their deposits and enables borrowers who reap the rewards of taking on debt.

- The policy is poisonous for banks. Theoretically, banks can survive in a negative interest rate environment as a bank can earn a spread between the rate that they pay a depositor and the rate at which they make loan. However, this only assumes that depositors will continue to accumulate savings in a bank that charges them for the right to have those funds stored there. At some rate, alternatives such as crypto currency, gold or cash notes are acceptable alternatives.

“If at First You Don’t Succeed, Get a Bigger Hammer”

OK, now to answer the $1 trillion question that you have been patiently waiting to ask. Namely, will the Federal Reserve (Fed) head down the path of implementing a Negative Interest Rate Policy (NIRP)? Although we at RSW have not joined the chorus of prognosticators calling for a U.S. recession, there are many forces at work that could drag our economic activity into negative territory. From plunging global trade, to stall speed growth in Europe, to a toxic domestic political environment, to a $16 trillion in global debt that is already sporting negative yields, the number of potholes dotting the landscape are growing. So again, while a U.S. recession or NIRP are not our base case forecast, it is not ridiculous to ponder the possibility that the Fed could be dragged down this policy cesspool of a NIRP at some point in the future. While there are many warning signs to monitor, the shape of the yield curve to us at RSW is of tantamount importance.

As we have already seen this year, longer-maturity U.S. Treasury Bond yields have plunged to multi-year lows to fall below those of shorter-maturity debt. As the rate of inflation and economic activity continue to slow, in response, it is likely that the Fed will continue to cut short-term interest rates. The good news is that there are still positive rates that can be cut! The bad news is that as we have said since the middle of last year, the Fed’s interest rate policy has been too tight. In any event, if the yield curve does not respond by "steepening" as the Fed cuts rates (long term bond yields become meaningfully higher than short term rates), the Fed will face mounting pressure to make negative rates the norm. Ultimately, if the Fed cuts rates to zero (from the already low base of 1.75-2.0%), they will be left with the same non-conventional policies that have already been proven to be unsuccessful.

We believe negative yields pose a real threat to our financial and economic systems. While addressing the Dallas Assembly on September 27th, 2011 the CEO of the Federal Reserve Bank of Dallas, Richard W. Fisher, summed-up the risk of heavy-handed Central Bank tactics when he said:

"The legend holds that with his hammer in hand, Thor would be able to strike as firmly as he wanted … and the hammer would never fail … and never fly so far from his hand that it could not find its way back. Monetary policy is not Thor's hammer. It is an awesome weapon. But it has limitations. We must carefully harbor its power. If we deploy it incorrectly, we might level more than interest rates and destroy that which we seek to create. And if we let it fly too far from our grasp, we may never get it back. In conducting policy going forward, we must constantly bear this in mind."

Municipal Commentary

Tax-exempt bonds continued their solid performance during the third quarter, but the trend in yields was anything but a straight line. For example, ten-year maturity, "AAA" rated bonds carried a yield of 1.64% at the beginning of the period, reached a low of 1.21% on August 28th and closed at 1.42% on September 30th. Investors fearing slower global growth, uncertainty surrounding U.S. foreign trade policies and plunging global bond yields scrambled to purchase high quality fixed income securities.

In fact, during the quarter, contributions into the tax-exempt mutual funds continued their strong pace and for the year totaled more than $63 billion. These cash inflows along with additional demand sparked by an outsized level of bonds being called from investors and securities that matured, provided more than ample demand to absorb a high level of new issuance during the period. Even a record amount of new municipal bonds being issued during August, historically a quiet month, was distributed without causing the market to become overly saturated with inventory.

At this level of interest rates, coupled with our view that a recession is unlikely over the next twelve months, we are proceeding with caution. As many of our long-term investors can attest, RSW's portfolios are actively managed through a disciplined and methodical approach stressing risk management. To that extent, we do not seek to chase or force opportunities but instead seek to capitalize on them when they emerge. An example of this was our forecast on May 16th, 2018 when 10-Year U.S. Treasury Bond yields had exceeded 3.10% and we said: "a statement like this has only come from RSW two other times in our 13-year history (2008 & 2010's Meredith Whitney debacle). We believe the [investment] opportunity is now."

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