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RSW's Q3 2020
Fixed Income Newsletter

This "^" or That "v"? What's the Shape of the Economic Recovery?

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“We Need More Power”

With the Atlanta Fed projecting that third quarter GDP powered ahead by 34.6%, many prognosticators are of the opinion that the future pace of economic activity will retain its “V” shape economic recovery. Thus, they are speculating that the growth rate will continue its long recovery from the second quarter’s GDP record plunge of (-31.40%). However, even in this scenario, percentages can be misleading as a 34.6% rise won’t wipe out the previous (-31.40%) decline. As you probably guessed from following our logic and process over the years, we believe such an optimistic view of a fast paced continuation of the recovery is unlikely. In fact, we believe that the algebraic symbol for “power” (^), is the most likely shape of economic rate in the fourth quarter, as growth backslides from an impressive improvement in third quarter activity.

Anxiety Impacts Spending

The crisis began with COVID-19 and there is still great uncertainty about its spread, future lockdowns, a potential second wave and an eventual medical solution. As the economy went from lockdown to gradual reopening, it was accompanied by a sudden rebound in employment. With that being said, the social, political, and economic impact of the coronavirus continues to evolve as the pandemic has caused an anxiety epidemic. To date, the robust growth we observed was fully supported by a pent-up demand for consumption, stimulus checks and enhanced unemployment benefits. Now, with nervous consumers hitting the pause button on spending, the strength of the V- shaped recovery is dissipating.

With the latest data on monthly Personal Income posting the second weakest of the year, down (-2.70%), consumer spending has predictably faltered. In fact, after rebounding by +8.70% in May, spending has steadily declined to just +1.00% in August. Unfortunately, this trend could be further aggravated by a rise in the unemployment rate. This has the potential to occur, as the elevated levels of temporary job cuts could become permanent. Likewise, the once temporary reduction in employee hours worked are also at risk of becoming long lasting.

With millions of Americans grappling with sinking incomes, you would think that credit card balances must be soaring as citizens charge their necessities on cards. However, as can be noted in second quarter’s economic data, the opposite is occurring. Total household debt continued to fall with credit card balances declining by a record $76 billion. These lower levels of liabilities are not a function of surging delinquencies, but instead reflect the frugalness of consumers. With uncertainty giving way to anxiety, individuals have become less inclined to whip out their plastic to make purchases.

Powell Removes the Brakes

If you think Federal Reserve Chairman Powell is not observing this disturbing trend, think again! A revamp of monetary policy tends to be crafted during periods of crisis and this time is no different.

On August 27th, at the Federal Reserve's annual Jackson Hole, Wyoming symposium, Powell announced an even easier monetary policy. Specifically, the Fed has signaled that they are inclined to allow inflation to rise above 2% for a prolonged period. By allowing inflation to run hotter for longer, the Fed has departed from their 2012 policy which formally targeted 2% as a key trigger to start hiking short-term interest rates.

Aside from the effects of the pandemic, the Fed also acknowledged the deflationary forces unleashed by our society's aging demographics and technological advancements. Furthermore, the Fed has strongly encouraged action by Congress to buffer the economy from feeling the full brunt of these deflationary forces. However, at this juncture, it is probable that the toxic political climate has rendered the passage of meaningful fiscal policy to be out of reach for months to come. Without a fast-tracked level of unemployment benefits distributed, should the pace of unemployment rise, economic activity could contract markedly.

Fortunately, with all the above being said, there is also potential for a positive outcome. Should the feared surge in coronavirus cases fail to materialize and the number of hospitalizations fail to spike this winter, consumer confidence may rebound. This could result in the return of consumer confidence and related spending. Also, given the progress already being made in the development of a vaccine, should a breakthrough emerge, the environment could normalize during the first half of next year.

Looking Ahead, What Does This Mean for Municipal Issuers?

Various headlines in the popular press have implied that the impact of the virus on state and local government finances, to date, has been much better than originally projected. We are looking beyond those forecasts as we are mindful that virtually all such jurisdictions, except for the State of New York (New York addressed below), have fiscal years that end in June. Therefore, the impact of the pandemic, depressed only the last quarter of the fiscal year. Thus, the robust economic activity and strong levels of tax receipts scored in the first nine months of the fiscal year dampened the impact of the pandemic. It is also important to note that most states entered this "crisis" with strong levels of cash reserves, that provided a meaningful cushion from falling receipts.

Going forward, we remain watchful that a different situation could emerge as the gap between issuers who are healthy and weak expands. Those borrowers with a history of fiscal discipline and structural balance (foundation of RSW's credit research process), should out-perform their weaker counterparts.

In our opinion, now is not the time to reach for yield, but a time to respect risk. Credit selection is likely to be crucial for investors seeking to generate reasonable returns and preserve capital. Despite the efforts of the press to paint the municipal bond market with a "broad brush", the municipal market is comprised of over 60,000 idiosyncratic issuers, which of course is further defined by varying risk within each sector.

We at RSW remain confident that the preponderance of municipal defaults, as has historically been the case, should reside in the riskiest sectors avoided by our investment discipline. Namely, Health Care and Single/Multi Family Housing bonds. In addition, the sectors that are traditionally dominated by below investment grade borrowers (high yield) such as Continuing Care Retirement Communities and Nursing Homes should see an above average rise in their level of defaulted debt.

In this uncertain environment, RSW's investment strategy is unchanged and squarely focused on lending money to the most credit worthy borrowers. While credit rating downgrades may be in the offering for some of the strongest issuers, their creditworthiness is likely to remain in the high investment grade rating category.

As far as the interest rate sensitivity positioning of our client portfolios is concerned, the composites for each strategy are at or near their lowest levels of their respective inception dates. We have maintained an "actively patient" strategy and believe that our persistence will be rewarded. While being positioned with elevated levels of cash, shorter maturity and/or bonds carrying shorter call dates, we should be in a solid position to capitalize on the next opportunity. In short, we have been taking the necessary precautions for the likelihood that the economic recovery begins losing power " ^ ".

New York City and State

- Moody's downgrade of both New York state and New York City was fully anticipated by RSW and the municipal market.
- The State was downgraded from Aa1 to Aa2 with a stable outlook assigned. This rating is still a high grade rating.
- New York City was also downgraded to Aa2 from Aa1, however the outlook was kept at negative.
- The Aaa senior and subordinate ratings on the $39 billion of City TFA future tax secured bonds were affirmed based on the legal security afforded bondholders. The outlook remains negative.
- We believe that the state's current credit rating should remain in the "AA" category for the near and probable intermediate term assuming the pandemic stabilizes.
- However, we believe that New York City's General Obligation (GO) bond rating will continue to see downgrades and thus we will continue to avoid lending money to the city on a GO basis.

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