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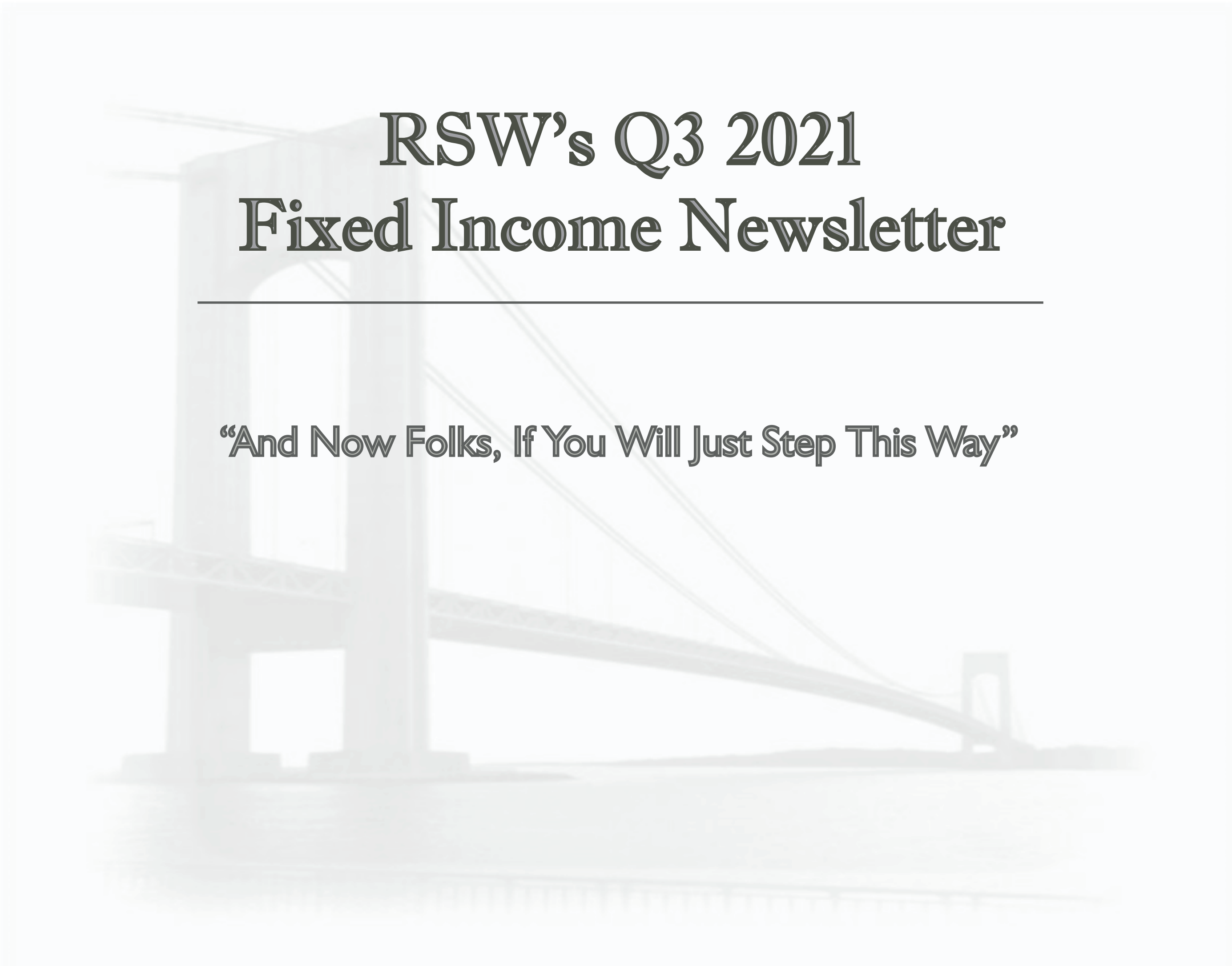
RSW's Q3 2021 Fixed Income Newsletter



"And Now Folks, If You Will Just Step This Way"

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"And Now Folks, If You Will Just Step This Way"

At RSW, we have been publishing these musings for 66 quarters and as you would expect from a firm that actively manages fixed income assets, have routinely shared our forecasts for inflation and deflation. All the while however, we have never uttered the term "stagflation". Well, that is about to change as the latest period has been marked by signs of dismal economic expansion and stagnant employment growth. In tandem however, prices for necessities such as housing, food, fuel, and energy have been rising at a blistering pace. This is classic Stagflation! But will it last? Please read on.

A series of unfortunate events have joined together to create this predicament. Globally, the rolling economic shutdowns due to COVID concerns have exacerbated production stoppages. Record low levels of supplies for many inputs, from semiconductors to workers, have increasingly acted as a constraint to output. To make matters worse, this dynamic is occurring at a time when manufacturers are seeing strong orders from surging demand.

Once products are manufactured, you would hope that the challenges end, but they don't! Products need to be "boxed". Well, that's where the process hits the skids. The supply of containerboard, which is used to package nearly all products, has reached an all-time low.

The struggles in the transport sector also serve to impede progress as this segment is "off the rails". Perhaps the least talked about challenge to move products around globally is a worldwide shortage of shipping containers. A scarcity of these 40-foot metal boxes is causing a ripple effect on supply chains, thereby disrupting global trade. Even when the cargo is loaded into the containers and finds their way on to the ships, the misfortune continues as a backlog of vessels look to enter the ports. A scarcity of laborers to unload the freight at the docks has contributed to a logjam that is greater than any other time in our country's history.

Now, enter stage left, the "Barker"

As you may recall, against this backdrop of economic stress highlighted above, it was the Federal Reserve who was downplaying the possibility of a surge in inflation. Moreover, for months, Fed Chairman Powell painstakingly explained that "Inflation Won't Get Out of Hand" and that any acceleration in the rate of inflation would be "transitory".

We at RSW have certainly not bought into this fairytale of temporary inflationary pressures. Instead, we believed that the issues at hand will persist longer than many expected. In fact, in our last report, among other price pressures that were discussed, we highlighted a growing risk that apartment rental prices were about to surge. Unfortunately, the latest reading on lease rates, according to Apartment List (a national index for U.S. rents) spiked by an astounding 16.4% this year, the most on record.

To glean a comprehensive picture of the inflationary issues, one needs to look no further than the headlines from the Federal Reserve's latest "Beige Book" report. Within, data is collected from regional Federal Reserve banks throughout the country to generate their results:

- "Even at greatly increased prices, many businesses reported having trouble sourcing key inputs."
- "All Districts noted extensive labor shortages that were constraining employment and, in many cases, impeding business activity."
- "With pervasive resource shortages, input price pressures continued to be widespread," the Fed said.
- "Several Districts indicated that businesses anticipate significant hikes in their selling prices in the months ahead."

As the news worsened during the quarter, pundits speculated as to whether the Federal Reserve would begin to reverse their "emergency" measures of policy accommodation. Will the Fed vote to scale back the size of their U.S. Treasury and Mortgage-backed bond purchases (Quantitative Easing, "QE") totaling $120 billion monthly? Will the Fed hike short-term interest rates? Will the Fed admit that their sanguine inflation forecast was folly? (Well, the last one was RSW's internal debate)

You are About to Witness Something Amazing, ...

To answer these questions, market participants looked to the minutes from the September Federal Open Market Committee Meeting (FOMC) which revealed that the economy is strong, the labor market is healthy, and inflation pressures should be transitory. If all that is true than why is Chairman Powell talking about the possibility of "tapering" their pace of asset purchases ($80 billion in U.S. Treasury and $40 billion in mortgage-backed bonds)? Why not come out with a set schedule to cease all future purchases? Furthermore, if they merely talk about reducing the size of the bond buying, isn't that still QE? Just less of it? If everything is so great, then why are there any emergency QE and zero percent interest rate policies still in place? In other words, if everything is going great, then why wouldn't you completely remove the emergency measures that were installed when things were horrible? Perhaps, it would be best if the Fed stopped the barking, and the nonsense was tapered.

With all the above being said, our questions are meant to be rhetorical in nature. Simply put, the Fed has placed themselves squarely in between a hammer and an anvil. Since the onset of the pandemic the Federal Government has been running massive budget deficits. To finance this extraordinary gap, U.S. Treasury debt has been issued.

Not widely talked about however is the fact that since March of 2020 the Federal Reserve has purchased roughly 50% of this newly created debt (source: FRED). Without this central bank intervention, the supply of U.S. Treasury bonds would certainly outstrip the demand by such a wide margin that interest rates would shoot higher. So, the Fed continues to walk a tightrope as they communicate with the investing community and the public at large. Clear messaging by the Fed can certainly lead to a spike in rates. Not only would this have economic implications but would also cause the interest expense on our nation's bloated level of debt to consume an even larger share of the government's tax receipts. Go ahead and continue to bark! "Knowledge is power only if man knows what facts not to bother with". (Robert Lynd)

"Every Exit is an Entry Somewhere Else"

While the economic data is shifting rapidly, RSW's base case rate forecast remains in effect. As we stated in our Q2 Commentary: "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!" Said differently, we believe that Stagflation will, over the coming months, morph back into Deflation.

While it may seem incongruous given the context of this report, our long-term deflation forecast (consistent since 2006) remains in force. Against a backdrop of extreme levels of over indebtedness, aging demographics, and relatively low wage growth, we continue to believe that elevated levels of market interest rates combined with shocking inflation, should prove to be unsustainable. For this reason, for years, each flare up in inflation and accompanying interest rate rise has caused economic and/or financial crises. In fact, the higher rates go, the larger the potential for severe repercussions.

By analyzing prior episodes, you will note that events typically turn ugly when the Federal Reserve overreacts, by "overtightening" causing economic activity and interest rates to fall precipitously. Perhaps, that is why they have been noticeably absent from acting to date. However, no action by the Fed also carries risks as the bond market participants could rush to sell bonds causing rates to rise, thereby tightening for the "Barker". The Fed should have already begun a rate hike campaign to temper these inflationary shocks. They had their chance. Now in our opinion, it's the bond markets turn to act.

In short, we believe that the next period of rising rates (best guess, ten-year U.S. Treasury bond yield reaches 2% plus or minus) should usher in the next period of declining rates. We are appropriately positioned for such an occurrence. Therefore, where suitable, we would view the next yield rise as an opportunity to reposition our client portfolios to lock-in higher earnings yields and capture greater levels of capital appreciation in the coming months.

Municipal Market Commentary

During the quarter, against the backdrop described above, the municipal bond mark was eerily quiet. In fact, using ten-year "AAA"-rated municipal bond yields as a barometer, the range for much of the period was only 13 basis points. We believe this lack of volatility is a sign that the municipal market is in a period of transition, most likely to higher rates over the coming weeks.

The next portion of the commentary is for "extra credit" as it specifically addresses an element of RSW's strategy and is a bit technical.

As RSW strives to strike a balance between maximizing income while preserving principal, the team may elect to hold higher levels of cash than is typical. Without a complete understanding of why the funds are in the portfolio, we would understand why it may be unsettling for an individual to see cash balances in an actively managed municipal bond portfolio. For some, it may be a concern that they are paying a management fee on the "idle cash". This worry would certainly be justified if RSW's portfolio management decision wasn't methodical, disciplined, and purposeful. In fact, the cash in the portfolio shouldn't be viewed in isolation, but instead as part of a strategic portfolio allocation decision.

Today, longer maturity/higher duration (measure of interest rate sensitivity) bonds are carrying a heathy yield advantage compared with bonds that carry shorter maturity dates and are less interest rate sensitive. Thus, for a portion of the portfolio RSW may elect to engage in a "barbell strategy". By combining cash and the longer/maturity/higher duration bonds the team can earn a higher average yield for the client portfolio compared to purchasing an entire portfolio of medium maturity (intermediate term) holdings.

Lastly, it is also the cash and near cash holdings in the portfolio that are readily available for our team to invest when we believe we are adequately compensated for the additional interest rate risk.

Thank you as always for your trust and confidence and we look forward to reporting back to you at the end of the year with our 2022 Market Outlook. Of course, you will hear from us sooner should market conditions warrant.

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