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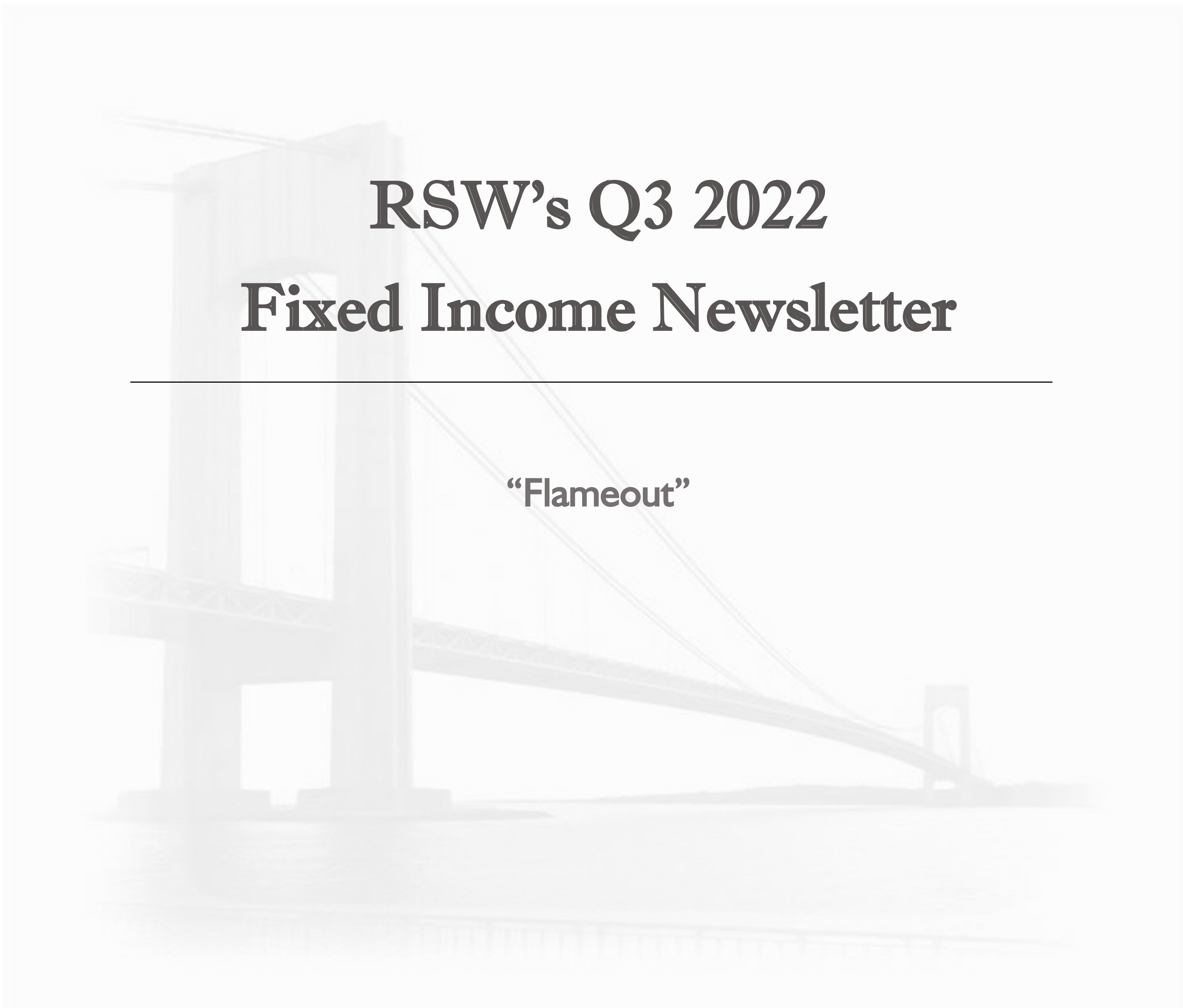
RSW's Q3 2022
Fixed Income Newsletter

"Flameout"



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"Flameout"

"Flameout" in a jet plane occurs when the flame that normally burns continuously is extinguished and the engine can no longer provide propulsion. For well over a decade, with an economy built on credit, the Federal Reserve has served as the flame that has provided the thrust to our financial system and economy. Even during time of crisis, akin to how a pilot can restart an engine during flight, the Fed has worked its controls and restarted our growth engine. Now, in a quest to squash inflation, Federal Reserve Chairman Powell is intentionally steering the monetary health of our country directly into turbulence. Will Powell's unrelenting endeavors cause a flameout?

Of course, our investors already know what we believe. In RSW's 2022 Outlook, prior to the first Federal Reserve rate hike of 25 basis points we prognosticated a likely path of events for the year. In that missive we said: "if the history of the Fed holds true to form and they overreact to yesterday's news by slamming on the monetary brakes…the Fed misses the turns, 'overtightens', and causes the next recession. We firmly believe this pattern will unfold yet again."

While we forecasted rapidly rising longer-maturity bond yields and a recession in 2022, we certainly didn't envision a (insert your own adjective) series of aggressive interest rate hikes during periods of contracting economic activity. This has simply never happened! (Source: FRED). Furthermore, while paying attention to Powell's latest comments, it becomes difficult to believe that the Fed has the navigation system to tame inflation without disturbing the financial system or crushing our Nation's growth rate ("soft landing"). Namely:

- The Federal Reserve "is strongly resolved to bring inflation down to 2 percent, and we will keep at it until the job is done."
- "No one knows whether that process will lead to a recession or how significant a recession it will be," Powell said. "I don't know the odds."
- "In addition, the chances of a soft landing are likely to diminish to the extent that policy needs to be more restrictive or restrictive for longer."

Below the Hard Deck

Powell's goals are numerous as he seeks to strangle the pace of inflation by slowing economic activity, thereby resulting in softer labor market conditions and lower asset prices. At a recent speech in Jackson Hole, Wyoming, he told households and businesses to prepare for "pain" as he announced his efforts to throttle back our nation's growth rate. The Federal Reserve has two main levers to accomplish their goals. While most investors are preoccupied with their prominent tool, interest rate policy, the fluctuations in the size of the Fed's balance sheet should not be discounted.

During the height of the pandemic, to ensure the financial system was flush with cash and keep the credit markets functioning, the Federal Reserve ramped-up the size of their balance sheet by increasing their purchases of U.S. Treasury and mortgage-backed securities; aka Quantitative Easing (QE). During the process, the balance sheet expanded by a whopping $5 trillion, rising from pre-pandemic levels of $4 trillion to roughly $9 trillion at the 2022 peak. While this process achieved the Fed's goals, it wasn't without cost as the monumental injection of liquidity contributed to the inflationary spiral that we are facing today.

Now, in the spirit of tightening monetary conditions, Chairman Powell has announced a "Quantitative Tightening" (QT) policy. Here, the Federal Reserve is reversing course and is planning to reduce the size of the Fed's debt holdings on the balance sheet by approximately $95 billion per month. To put this reduction into perspective, while implementing their

QE strategy, the Fed was expanding the balance sheet by purchasing $85 billion ($45 billion U.S. Treasury and $40 billion mortgage bonds) bonds per month. As an aside, if all of this sounds like an eighth-grade science project it's because in our opinion, all of it is!

Putting aside the Federal Reserve's interest rate hikes which could take six to twelve months before their full effects to slow growth become evident, the effects of QT are rarely debated. In fact, there doesn't even appear to be a consensus view from economists or Federal Reserve Board members as to the impact of QT. This is all a dubious exercise, especially when both Federal Reserve levers are being pulled simultaneously.

Trouble in the Fuselage

Having held the view that the Fed's monetary tightening plans are yet another irrational policy approach, in this year's second quarter commentary we said: "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."

Unfortunately, during the third quarter, we entered another disturbing phase of the cycle as liquidity in the U.S. Treasury bond market receded, causing the volatility or fluctuations in security prices to become extreme. This can be measured by Bloomberg's US Government Securities Liquidity Index, which is indicated "stressed" conditions, with measurements reaching levels not seen since the height of the pandemic. During prior episodes of stressed liquidity, the conditions in the U.S. Treasury bond market morphed into lesser quality asset classes causing further dislocations. This process appears to be well under way.

A less talked about economic disturbance caused by Chairman Powell's interest rate hikes has been the negative impact to the economies of countries that are thousands of miles away. With U.S. securities now offering relatively high risk-adjusted yields, foreign investors have flocked to the dollar to facilitate investments in the United States. This outsized demand for dollars has been a key reason the "greenback" has surged to twenty-year highs versus a basket of world currencies.

There are three key ramifications of a relatively strong dollar. First, the inflation rate of foreign nations spikes. This occurs as foreign citizens purchase essential items which are traded in the global markets in dollars, with their devalued currency. Secondly, this puts additional pressure for the foreign central bank to raise interest rates to lessen an inflation problem at a time when their economy may be fragile. Lastly, to make matters worse, many emerging market countries issue debt denominated in dollars to facilitate their borrowing. As the local currency weakens versus the dollar, the cost of the repayment of principal and interest becomes more expensive.

The impact of rapidly rising interest rates is also serving to wreak havoc on the housing market. With housing related activity comprising 16.7% of GDP (Source: NAHB), it is likely that this sector will remain a meaningful detractor from growth for months to come. A key reason is affordability, or lack thereof. For the last two years, home prices nationally have risen by an average of 33%. This, combined with higher mortgage rates and wages that have fallen short of inflation, has pushed the "housing affordability Index" to levels that are lower today than before the start of the "Great Recession".

However, a price reversal may be under way. During the month of July, the FHFA Price Index fell six tenths of a percent, the second largest decline on record. Furthermore, despite the spike in the price of rental apartments, the housing-price-to-rent ratio is at record highs, exceeding the level scored during 2008. As this ratio rises it means that the rental option becomes more attractive.

As with any boom in price, and with housing being no exception, a correction should not be complete with just a "dip" in price. If it did, this could be one of the first "bottoms" that was ever put in that was so close to the top. Let's also be mindful that the Fed Chairman has also had a lot to say about the housing market. Recently Powell said: "it would be a 'difficult correction', but one that is necessary to put the housing market back into "better balance."

Final Approach

Chairman Powell finds himself in a similar position to many predecessors who were at the helm. The Fed is stuck between a rock and a hard place, and the dilemma appears to be self-inflicted. As we said in RSW's 2021 Outlook as it pertained to Fed policy: "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." Where are we today? Our nation's growth rate that was once propelled by "jet fuel" (Zero percent rates, QE and stimulus monies) has been burned and what we are left with is the wake of higher prices and formidable headwinds, such as:

- Single Family home prices, nationally on average, that are the least affordable on record.
- Global disruptions to economic activity exacerbated by a strong dollar.
- Individuals falling further behind, as wages fail to keep pace with the rate of inflation (Source: Bloomberg).
- Personal savings as a percentage of disposable income falling near record lows (Source: FRED).
- A Fed that openly talks about inflicting economic pain to break the back of inflation.
- With all the chatter about strong employment growth, a record number of people are working multiple full-time jobs.

The impact of the Fed's overtightening campaign to the domestic and global economy is the equivalent of a "bird strike" and unfortunately Powell doesn't have the deftness of Captain Sully. The deflationary effects of a housing debacle, a sharp contraction in the demand for credit, and a weakening job market, should soon become evident. Given the formidable headwinds that the economy is facing today, we remain convinced that the deflationary effects will be even more pronounced during this cycle.

Notwithstanding that we were too early in our call for a "strong buying opportunity", as was posted in RSW's second quarter commentary, we reiterate our "Strong Buy" suggestion. Simply put, we do not believe that today's higher rates are sustainable. As we said then and firmly believe today: "With history as our guidepost…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".

As of today, the U.S. Government bond market is on track to post its worst annual total rate of return in history. While this broadly frames the last nine months, it doesn't serve as a forecast as to what is likely to unfold over the over the coming quarters. As MIT professor Rudi Dornbusch said, "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

Municipal Commentary

Against a backdrop of aggressive Fed tightening and liquidity being quickly drained from the financial system, virtually any asset with a price was punished during the quarter. Municipal bonds were no exception, as directionally, tax-exempt yields tracked the direction of those in the U.S. Treasury bond market. With most of the drubbing taking place in September, for the quarter, the broad market as measured by the Merrill Lynch Municipal Bond Index, posted a return of (-3.46%). The severe price declines further exacerbated the year-to-date "bear market" returns, which totaled (-12.13%).

During the quarter the outflows from mutual funds ebbed and flowed before the sharp pace of redemptions was reestablished. In fact, for the year, the amount of money being yanked from the mutual funds has already exceeded the 2021 record year of inflows. With that said, despite the amount of bonds that needed to be sold by mutual fund portfolio managers to meet shareholder redemptions, the liquidity in the tax-free arena has been relatively strong.

In terms of tactical positioning, when municipal bond yields were near the zero bound, we had a "strangle hold" on the level of duration (measure of interest rate risk) for each portfolio strategy. As rates spiked higher, we incrementally extended the duration to end the third quarter near "neutral levels" with respect to our benchmarks. Although we have been tempted to increase the interest rate sensitivity of our client portfolios to above average risk levels, we have continuously postponed this decision.

With bond prices continuing to decline, at this juncture, we believe the risk-to-reward in the market has shifted to where we believe we are compensated to modestly dial-up the amount of portfolio interest rate risk. To this end, where applicable, we are beginning the process of exchanging a portion of the bonds that were once selected for their "defensive" characteristics (shorter call and/or final maturity dates) for higher yielding bonds, with greater levels of interest rate sensitivity. Simply put, these types of transactions afford us an opportunity to capture the elevated market yields for longer periods of time.

In terms of credit quality, we will continue to lend monies to borrowers who we believe to be of the highest credit quality. When opining on an issuer's creditworthiness, our opinion is not swayed by "one-shots to balance a municipalities budget", stimulus monies used to plug deficits, or financial shenanigans. Even during periods of the highest levels of financial stress, our disciplined research process has served to protect principal. Lower-rated borrowers, on the other hand, to which we do not invest, should experience greater financial pressure during a "deep recession" (RSW's base case).

This environment has been stressful for many investors and that anxiety is certainly understandable and not lost on us. As active portfolio managers, we are relied upon to look at the landscape through a calculated lens and our disciplined and methodical process is designed to do just that. As always, thank you for your trust, confidence, and consideration.

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