Normal (3/9/2017)

The Great Recession gets most of the blame, but US growth has been decelerating for decades. The term "new normal" was coined to describe a changed US economy but those changes are approaching middle age. It may be more accurate to say it's "the normal that's older than you think".

As we have espoused for over a decade, the structural forces of a low birth rate, low productivity, and low wages together with high debt and high income disparities, are stronger forces than monetary and fiscal policies. Just ask China and Japan.

We encourage our readers to pay attention to certain clues that will serve to illustrate our points. There is a near consensus among economists that the economy is improving as consumer and small business confidence soars and other sentiment surveys show similar improvement. At the same time, the Atlanta Fed GDPNow forecast for the first quarter has been steadily reduced from 3.4% earlier this year to 1.2% currently.

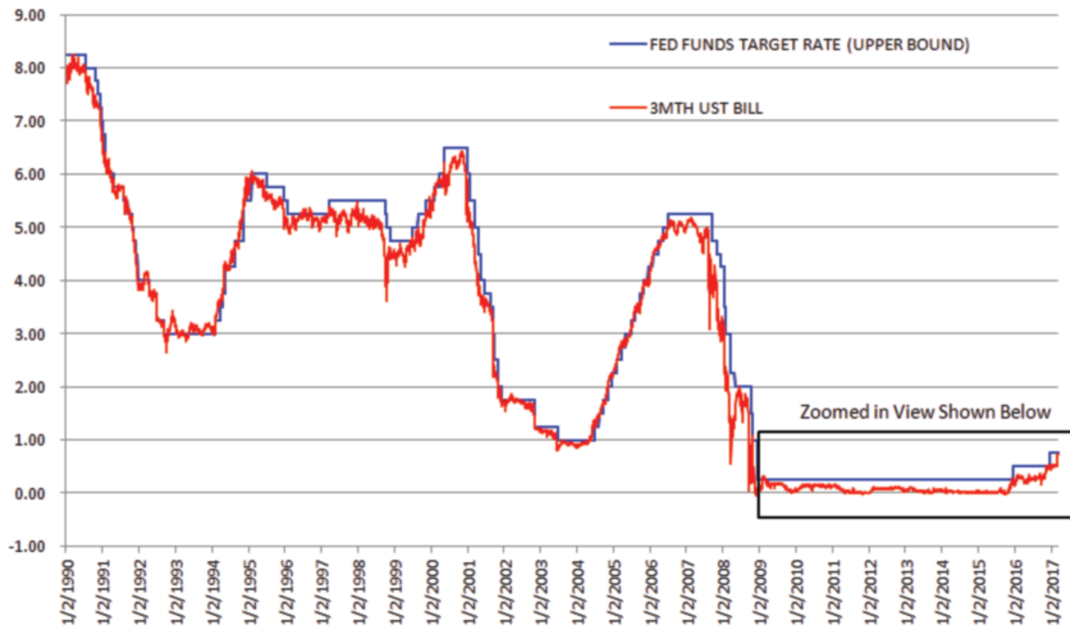
Time will tell whether the economic data converges up to the sentiment or sentiment decelerates to the actual data. At RSW, we respect the improved confidence, the question is whether disposable income can accelerate enough to facilitate sustainable real growth. When the cost of what you need (rent, medical care, etc.) outpaces incomes, the things you want are sacrificed. So, while inflation has risen, we believe it will be unlikely that it will translate into higher wages. As such, real disposable personal income y/y growth actually peaked in December 2014 at 4.7%, and has since decelerated to 2.0%.

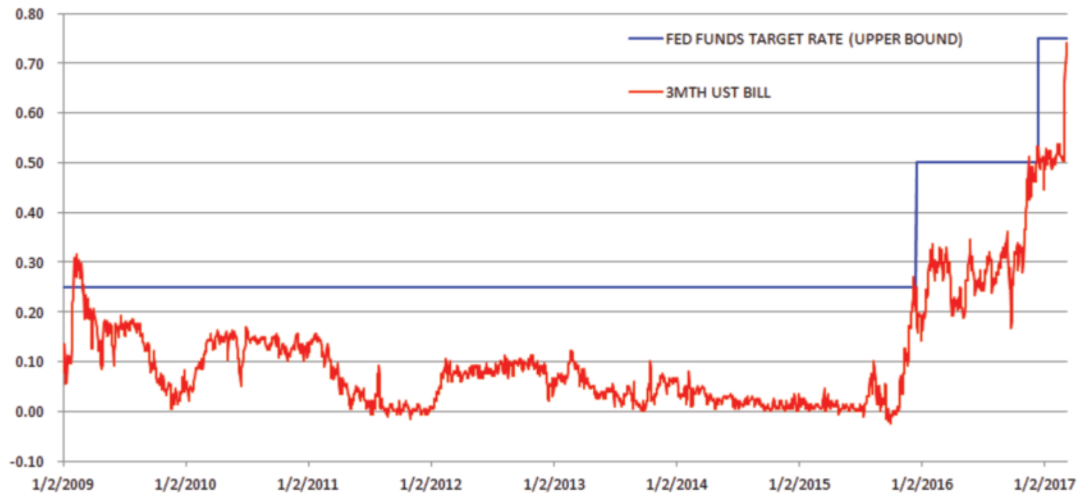
Fed Funds Rate

Why is the Federal Reserve so interested in hiking the overnight Federal Funds Rate when growth is at a stall speed, and by their own forecast likely to be remain at or below 2% for the next several years?

We believe that the Fed wants to remove the emergency rate accommodation and “re-stock” the rate shelf with basis points so that they will have the ability to cut rates should the next crisis or recession unfold.

While all eyes remain glued to the Federal Reserve's actions, it is important to note that since 1990 the Fed has not led the interest rate markets, but instead has followed. If you look at the chart below you will note that the yield of three month Treasury bills has always moved higher or lower ahead of the Federal Reserve's decision to adjust rates. It's almost as if the Fed asks the bond markets permission to move rates and if granted by the Treasury bill market, are given the green light.





Furthermore, not only have the Fed members not controlled short term rates but they certainly do not control longer maturity market yield levels. As you may recall, during the 2005 to 2006 rate hike campaign, longer maturity bond yields leveled off.

Strategy

Since November, we have been respectful of the fact that sentiment can take the market to a place not warranted by fundamentals. With that said, should 10-year US Treasury bond yields surge toward 2.80% (level mentioned in RSW's 2017 Investment Outlook), we would embrace that move as an opportunity, not something to be feared. Since much of President Trump's policies are still on the drafting table, there are two things that we know for sure:

1- Not only have bond markets pre-paid for the enactment of Trump's policies, but the subsequent success of those policies as well.

2- Negative effects of higher rates, which have been brought about by Trump's election, have now been detracting from economic growth for four months.

Lastly, it is important to note that there is typically a three to six month lag between a yield surge of 40% to 50% and a meaningful slowdown in economic activity. Thus far, 10-year US Treasury bond yields are up approximately 38% (1.85% to today's 2.56%) since the election.

Stay tuned and we look forward to keeping you informed.

This document was prepared on 3/9/2017 and is not intended to be a solicitation of Firm interests. Past Performance does not guarantee future results. Investments are subject to risk and may lose value. The information is not warranted as to completeness or accuracy, nor does it serve as an official record of your account. RSW Investments does not render legal, accounting, or tax advice. Please consult your tax or legal advisors before taking any action that may have tax consequences.

This report has been prepared by, and reflects the views as of this date of, RSW Investments, LLC [RSW hereafter]. RSW's views and opinions are subject to change. Investors should consult their attorney, accountant, and/or tax professional for advice concerning their particular situation.

All views expressed in the research report accurately reflect the Managing Member's personal views about any and all of the subject topics. No part of the Managing Member's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the Managing Member in the research report.