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RSW's 2019 Investment Outlook

Made You Flinch

Municipal Bond Commentary: A Year in Review Fourth Quarter 2018

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Made You Flinch (12/20/18)

Happy Holidays and Best Wishes for a Happy and Healthy New Year.

With the books almost closed on 2018, we grapple to find one word that can best describe this year's events. One thing is for sure, no one can say it was boring. As a diversified investor, the year began with excitement, elation and euphoria, but later in the year positive emotions yielded to discontent, disillusionment and disappointment.

2018 Flash Summary

Surging economic activity and record low levels of unemployment produced fears that the economy would "overheat" causing wages and the general level of inflation to surge. As the year unfolded, the higher inflationary readings, although modest, led to a robotic pace of Federal Reserve rate hikes and an unprecedented "Quantitative Tightening" (discussed below). The rise in short-term interest rates and projections for further Federal Reserve driven rate increases caused the yields on longer maturity bonds to rise. Throughout much of the year however, short term interest rates rose at a quicker pace compared to those of longer maturity bonds serving to “flatten” the yield curve.

Concerns that the Fed "over-tightened" emerged in the second half of the year as a much flatter yield curve produced fears of a coming recession. Aside from the tumult, which began in the bond market, political uncertainty, trade wars, a ballooning federal budget deficit and a surging U.S. dollar rattled prices of riskier assets including the values of emerging market stocks and bonds which relentlessly submerged.
Before pushing ahead, let's review RSW's 2018 prognostications versus the actual data:

Interest Rates:

Forecast: "Any yield rise (10-Year U.S. Treasury bonds) should be capped at 2.90%"
Actual: 10-Year U.S. Treasury Yields peaked at 3.24%

GDP:

Forecast: "2.30%"
Actual: 3.125%

Inflation:

Forecast: "1.65% as measured by the Core PCE (Personal Consumption Expenditures Index, excluding food and energy)
Actual: 1.78%

Additional forecasts: Quotes from RSW's 2018 Commentaries:

2018 Outlook (1/5/18):
"Will Goldilocks (reference to a not too hot or too cold investing environment) get flattened by the curve?" "During these 'everyone owns the hot assets and I don't' periods, the importance of diversification may be difficult to appreciate. Only when the financial conditions become unfriendly do we fully recognize it's true worth".

Intra-quarterly (Rates Matter 2/5/18):
"As we entered the year, we held the view that 10-year U.S. Treasury bond yields could reach 2.90%. While we are close to that level, and tempted to materially alter our current defensive stance, we will remain cautious".

Intra-quarterly (The Time is Now 5/16/18):
"With 10-year U.S. Treasury bond yields at 3.10%, we are ready to release RSW's third strong buy recommendation in 13 years".

Second Quarter 2018 Commentary (How long can the Federal Reserve Hold a Plank 7/9/18):
"Our nation's high levels of debt and related escalating interest expense payments are causing the U.S. economic muscle to atrophy".

Projections for 2019? Not so Fast!

Before we can offer projections about 2019, we need to frame our Nation's odd predicament in order to provide context of our views. Yes, portions of this segment may be considered to be territory that has been well traveled by RSW or perhaps even tedious, but please stay with us.

It has now been over 10 years since the great financial and economic debacle of 2008. To avoid a depression during the "all asset class meltdown", the Federal Reserve took unprecedented measures to flood the financial system with cash. A zero percent interest rate policy was initiated in mid-December 2008, and to provide an even greater level of stimulus, a financial experiment known as "Quantitative Easing" (QE) was embarked on.

Here, the Federal Reserve essentially created new monies to purchase Treasury bonds and mortgage backed securities from the banks. One objective of this strategy was to ensure that market yields for longer maturity debt stayed low for an extended period of time. Over the next 6 1/2 years, QE related purchases of debt soared to roughly $3.6 trillion, bringing the total holdings on the Fed's balance sheet to equal $4.4 trillion.

At its core, the Fed's policies were aimed at driving-up the value of all asset classes to reignite the confidence of consumers, lenders and investors. Against a backdrop of "free money", the price of riskier assets was considered to be "spectacularly cheap", enticing a variety of speculators and investors to borrow monies to acquire securities, commodities and real estate.

This process was in general, self-reinforcing, as stronger economic growth was supported by rising incomes and net worth. This further enabled a borrower to take on even greater levels of debt. As the animal spirits continue to take hold, investors develop a "FOMO" or “fear of missing out” complex. It's precisely at times like these where investors abandon the concept of diversification and begin to question why they own the asset classes that haven't delivered stellar returns.

As greater risk taking was rewarded with total rates of return that exceeded historic norms, investors increased their leveraged positions by borrowing short-term and lending for longer durations. These leverage transactions, also known as "carry trades", took on many forms such as investing in illiquid assets and riskier debt securities, as well as borrowing in one currency and lending in another. All the while, the level of debt rises and the cost to service that debt rises even faster.

During this period of "money for nothing", corporations also chose to forgo the concept of building and investing for long-term value. Instead, many CEO's decided to sit on their cash and ramp-up purchases of their own stock by borrowing trillions. This spike in corporate borrowings inflated the size of the U.S. investment grade bond market to over $5 trillion. That crushing amount of debt put downward pressure on the credit ratings assigned to corporate issuers. Roughly 49% of the market is now rated "BBB" (the lowest investment grade rating category issued by Standard & Poor’s), versus just 35% in 2006. In fact, the amount of bonds carrying a "BBB" rating today is greater than the size of the total investment grade market was back in 2008 (*Bloomberg*).

Too much Fed!

During 2018, the Federal Reserve has been steadily reversing course to ensure that the huge waves of liquidity provided during the crisis years are receding. The Fed Funds rate currently stands at 2.50%, up 2.25% since the rate hike cycle began in December 2016. While many prognosticators "fired-up" their Artificial Intelligence (AI) Algorithms, to see how high the Fed can lift rates, we fired-up our process and common sense.

It's just math! If during the last Federal Reserve tightening campaign (ended on June 29, 2006) the overnight target rate topped out at 5.25% and virtually all outstanding Treasury and corporate debt levels have ***doubled*** since that time, where should the rate top out today? Shout it out if you know the answer. If not, let's work through the analysis. Let's assume that in 2006, the annual interest expense on $100 of debt was <u>$5.25</u> ($100*5.25%). So, if we were to ***double*** the amount of debt ($200), then wouldn't it make sense that only roughly one-half of the annual interest rate would produce the same level of annual interest

If the Fed Funds Rate now stands at 2.50%, should we already be at the breaking point for the economy and financial markets? YES!... But Wait...There's More! When we couple this illustration with RSW's longstanding themes of low income growth, weak demographics, etc. the predicament looms larger.

Fed Up!

As we discussed throughout this musing, raising short term rates is not the only lever that the Fed can pull to slow the pace of economic activity and inflation. In tandem with this policy, they have been busily experimenting with reversing their QE experiment, with another research project known as "Quantitative Tightening" (QT).

This program is the mirror image of QE, whereby the Fed is seeking to tighten monetary conditions by reducing the size of its balance sheet that was ramped up during QE. To accomplish this shrinkage, each month the Fed is letting $50 billion ($30 billion Treasury, $20 billion mortgage bonds) of holdings mature without purchasing new bonds with the proceeds. To put this reduction into perspective, at the peak of QE, the Fed was expanding its balance sheet by purchasing $85 billion ($45 billion Treasury and $40 billion mortgage bonds) per month.

As you can tell from the above statistics, the reduction in the current size of the QT program is significant, as it is equal to more than half of the size of the purchases added at the peak. Yet, it is one of the least discussed policies by pundits and money managers. Remember the days of QE? Everyone was flapping their gums about the potential cause and effects of that unprecedented financial experiment. Now, it's all about where the Fed will take the overnight target rate and all you hear are *crickets* on QT. When you couple the Fed's QT policy with persistent rate hikes and an enormous escalation of public and private debt, it should become apparent why we have thought for months that the Fed had already "over-tightened".

Why is the Fed consistently wrong?

Not too hot, nor too cold is a story of "Goldilocks", not the track record of the Fed's economic forecasting or interest rate decisions. In our opinion, the two biggest problems with most central bank policies are (1) monetary policy acts on at least a 6 to 12 month lag and (2) the models they use to determine policy have been proven to be incorrect. From where we sit, it's also important to track whether income levels are rising fast enough to cover the servicing of debt. Whether or not debt can be paid back carries massive implications for the future trajectory of growth and inflation. When debt can't be repaid it becomes "Time to Pay the Piper". While we don't know exactly who the heck the "Piper" is, what we do know is that he tends to usher in an ugly deleveraging process.

Deleveraging leads to Deflation.

The huge waves of liquidity that were formed to acquire assets since 2008, are in the latter stages of receding. When the limits of debt growth relative to income growth are reached, the process of prosperity gets thrown into reverse. Specifically, asset prices fall, corporate debtors face challenges servicing their debts, banks turn cautious and become less willing to extend new loans. As it becomes difficult to borrow funds, the system becomes starved for liquidity and causes individuals to curtail their spending habits.

With the flow of money being circular, the vicious cycle continues. Since one person's spending is another person's income, if spending declines, incomes will also shrink. This erodes the ability of borrowers to make their principal and interest payments. The layoffs soon follow as declining revenues reduces a company's cash on hand and forces them to reduce their expenses.

Conclusion

While many bond investors were concerned that the 10-year U.S. Treasury bond yield could breach 4%, we too were also concerned, but not for holders of high quality bonds. While lower bond prices caused some investors to flinch and reduce their bond holdings, our elevated levels of anxiety were focused on the declining financial health of the global economy. This stems from our long standing belief that higher yields themselves act as a "self-breaking mechanism" to produce slower growth when the economic underpinnings are fragile.

Federal Reserve Chairman Powell and the risk markets appear to have caught up to concurring with us. Historically, Fed Chairmen have attempted to put on "the brave face" when the risk markets get jolted, then finally succumb to lower prices. This Chairman is no different. In fact, he flinched when the stock market slide deepened and changed his stance on the need for a multitude of rate increases. For example, on October 3, he stated that "interest rates are still accommodative and that they are a long way from neutral." On November 28, he reversed his position and said that the "Funds rate is just below the broad range of estimates of the level that would be neutral for the economy."

Looking ahead to 2019, the investing environment should continue to be "tricky" (technical term), and volatile and long-held beliefs will be tested. In short, an environment that should be ripe for total rate of return managers to adjust portfolio positioning and capitalize on the opportunities that should be afforded by a shifting landscape. At RSW, we believe that a methodical and disciplined approach is the best defense to prevent the Flinch!

Prognostications:

Interest Rates:

Forecast: "Persistent volatility with enhanced opportunities to boost/preserve principal

Using the 10-year U.S. Treasury bond as a proxy, yields should continue to be relatively well behaved, as 3.25% should cap any upward rate movements. A meaningful dollar decline coupled with a surge in oil and other commodities could cause a temporary yield spike.

Should the Federal Reserve continue to hike rates in a manner that is inconsistent with weakening economic activity, longer-maturity bond yields can fall precipitously."

GDP:

Forecast: "2.00%"

Inflation:

Forecast: "1.40% as measured by the Core PCE (Personal Consumption Expenditures Index, excluding food and energy)"

Municipal Bond Market Commentary

Historical rewind

For much of the year, municipal bond yields were pulled higher on the back of rising U.S. Treasury bond rates. For example, 10-year "AAA"-rated tax-exempt bond yields opened the year at 1.98% and peaked in November at 2.77%. This 79-basis point increase compares to the 83 basis point increase witnessed in 10-year U.S. Treasury bonds, where rates crested at 3.24%. Since the beginning of November, however, municipal bond prices have surged led by 10-year "AAA"-rated yields which have fallen by 42 basis points as of this writing.

During the year, aside from the difficult backdrop of rising U.S. Treasury rates, municipal bonds experienced a series of cross currents. Lower levels of new issuance and stronger demand from life insurance companies arising from the new tax legislation, served to provide overall support for the market. However, offsetting this tailwind was heavy selling from some institutions, such as banks, due to the lowering of the corporate tax rate to 21%.

Furthermore, bond prices were pressured by relatively heavy mutual fund selling as individual interest in the municipal bond market faded. Predictably, individuals sought to sell bonds as yields were rising. As always, they seemed to flinch and got the "Yips" (technical term) when prices declined and the Fed spoke about further rate hikes. The somewhat "offsetting" forces mentioned above resulted in a predictable

pricing dynamic vis-à-vis the U.S. Treasury bond market. 10-year "AAA"-rated municipal bond yields were valued in a range between 82% and 86% of comparable maturity U.S. Treasury bonds for much of the year.

Ahead

Looking ahead to 2019, the technical backdrop is a bit cloudy. We expect the level of new issue supply for next year to be similar to the 2018 level. We expect a rather subdued pace as the tax legislation knocked out the ability of issuers to "advance refund" their debt ahead of the stated call dates. These transactions used to account for over 20% of the average yearly volume of new debt issued every year.

In the upcoming year, the volume of bond calls, maturing securities and coupon income, while expected to exceed the pace of new bonds being issued (net negative supply), is likely to do so by a smaller margin than experienced in 2018. For example, in 2018 net negative supply (new issuance minus coupon payments, bond calls, and maturing bonds) should come in at approximately (-$97 billion) while net negative supply for the year 2019 is expected to tally only (-$58 billion).

Given the economic slowdown that RSW is expecting to unfold in 2019, coupled with outsized financial market volatility, we expect stresses in weaker issuers to loom larger. The pension obligation issue is of crisis proportions in several states that are large borrowers in the municipal bond market. Specifically, Illinois, New Jersey, Connecticut and Pennsylvania are challenged issuers who we have written about at length in prior commentaries.

Careful

In a low interest rate environment, it is quite common for high yield borrowers to issue vast volumes of riskier debt as it is easily digested by the marketplace. The surge in demand for yield by individual investors creates an environment whereby a professional manager can "market" higher total rate of returns and cite their trading prowess as the reasoning for that strong performance. However, a portfolio turnover rate that only falls in the 10% to 20% range, cannot produce outsized returns in a high quality tax-exempt bond portfolio. The reality is that such a manager may be constructing a laddered portfolio full of "odd lot" positions in smaller, illiquid, lesser quality issuers.

There are only several levers that a manager can pull to influence returns: credit, sector, duration management, maturity positioning and issuer selection. Communicating to clients that the spectacular returns are being generated by active trading, when the level of turnover is minimal, cannot produce outsized returns.

We cherish the seat that we have at the table with Financial Advisors and clients. We will never take for granted the trust and confidence that you all place in us. The strong deflationary forces that are ahead should cause the weaker borrowers to become a lot weaker. Given this outlook, we will continue to maintain our cautious approach as we are only seeking to lend monies to the highest quality borrowers. The vast pools of liquidity are receding steadily. As Warren Buffet once said: "You never know who's swimming naked until the tide goes out."

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