RSW INVESTMENTS

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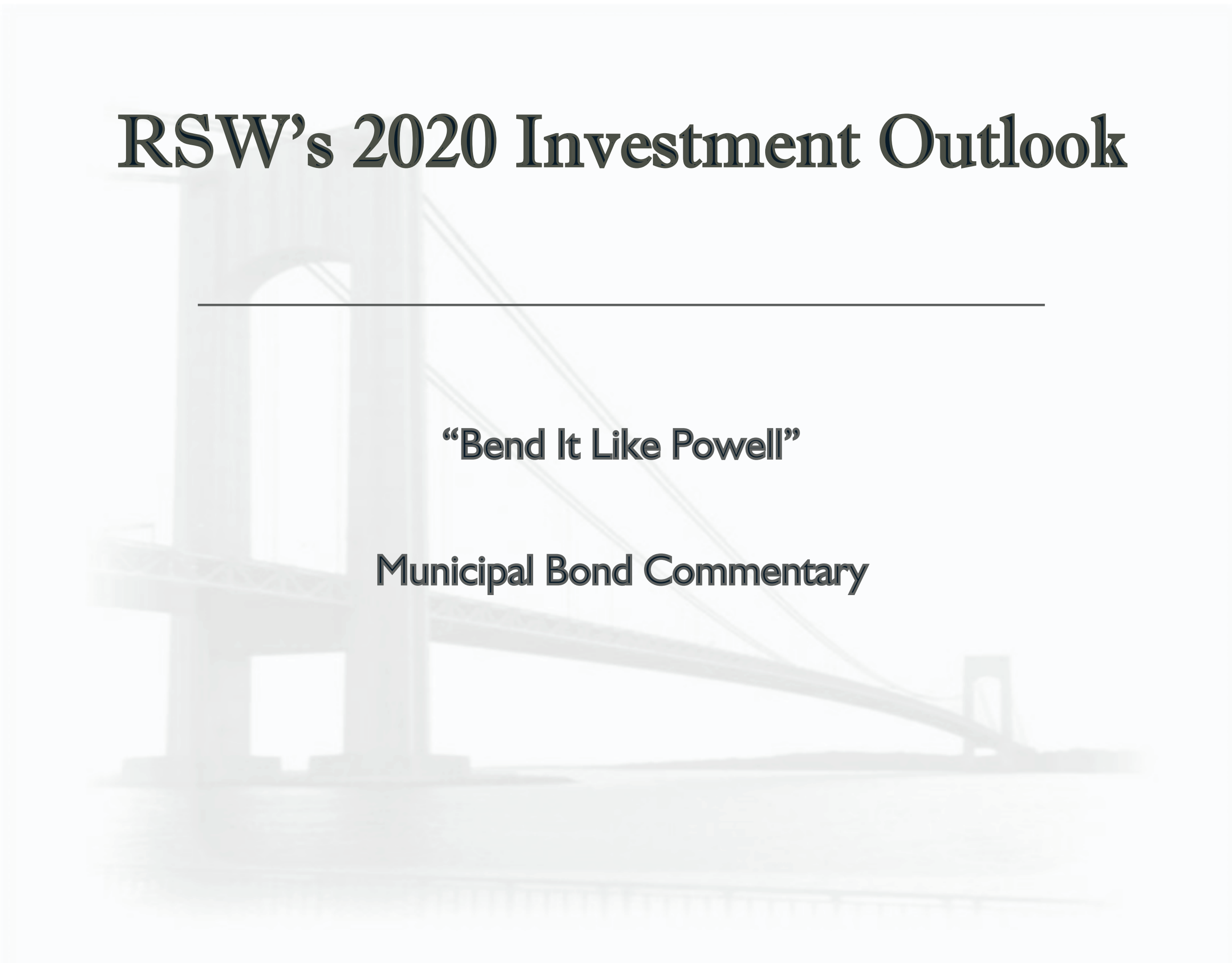

RSW's 2020 Investment Outlook

"Bend It Like Powell"

Municipal Bond Commentary

RSW Investments Holdings, LLC ▪ 47 Maple Street, Suite 304 ▪ Summit, NJ 07901-3647 ▪ (908) 608-9600
www.rswinvestments.com

“Bend It Like Powell (12/19/19)

Without question, David Beckham was one of the most prominent soccer players (“footballer”) in the world. In the 2002 movie *Bend It Like Beckham*, the title references Beckham’s ability to control the curve of his shot while attempting to pass or score a goal. While Federal Reserve Chairman Jerome Powell certainly does not look like a footballer, he too is attempting to influence a curve with finesse. Namely, using monetary policy, Powell is attempting to shift the shape of the yield curve from flat to positively sloped (longer rates exceeding short). However, while there is a mathematical equation (Y_d= R-SQRT (R^2-D^2)) to calculate the many factors that influence the path that a ball will arc, the Fed appears to lack the formula to achieve their desired goals.

In March 2019, the U.S. yield curve inverted for the first time since August 2007. Specifically, the interest rate on 10-year U.S. Treasury notes fell below the rate on 3-month U.S. Treasury bills, a rare event. This is called an inverted yield curve and this occurrence has predictably caused economic activity to contract. When the yield curve is flat or inverted, the differential between a bank’s cost of funds (deposits) and where they could lend monies out for longer-time periods is narrow. With credit being the lifeblood of the economic system, when banks are not adequately compensated to make a loan, they tighten their lending standards and the opportunity to borrow and invest becomes scarce.

Do you recall the hysteria surrounding the inverted yield curve? Despite the concerns and the strong signal that it sends for meaningfully weaker economic activity, we at RSW refrained from joining the chorus of prognosticators who called for a recession. Furthermore, with market yields having already collapsed, we mentioned in RSW’s Q2 commentary that the bond market was already well on its way to “pricing-in" an economic contraction.

In October, the curve "normalized" as the yield on 3-month bills had fallen below the rates offered on 10-year U.S. Treasury notes. So, as you would expect, the “crowd” now feels more upbeat about our country's economic prospects. In fact, a November Bloomberg News headline captures this mood: “Recession warning of inverted yield curve looks so last year”. Further highlighting the optimism was an article in *The New York Times* titled, “The message from Wall Street is clear: The American economy is not in the kind of trouble that investors feared earlier this year".

While most are breathing a sigh of relief and feeling upbeat about our nation’s economic prospects, we are poised to once again fade the opinion of the masses. While a steeper yield curve can be viewed as a signal that the outlook for growth is favorable, it is not always the explanation. In fact, we believe that the recent optimism is misplaced and that a financial event could be unfolding.

Deleveraging Ahead: Check Your Junk

An interesting dynamic is unfolding in the taxable high yield bond market; AKA “junk bonds”. Junk bonds are issued by companies with too much debt, a shortage of free cash flow and therefore are among the most likely to default on their payments of principal and interest.

Quite often the trend in yields among the lowest tier of below investment grade borrowers (rated “BB” to “CCC”) moves in tandem. However, we are now noticing a diverging trend as the bond market is punishing the prices of bonds that are rated "CCC" and has paid higher prices for issuers that are rated "BB" and "B". This is causing the correlation of these varying issuers to fade. Relative to comparable maturity U.S. Treasury bonds, the yields of bonds rated "CCC" are climbing while those rated “BB” and “B” are falling.

It appears that the appetite to assume an increasing level of risk is dissipating as the $1.2-trillion U.S. leveraged loan (junk bonds) market is starting to experience an elevated number of credit rating downgrades. In fact, on a rolling three-month basis, the ratio of downgrades-to-upgrades spiked to 4.9. This means that for every issuer that was upgraded by the credit rating agencies, there were almost 5 issuers downgraded. On a rolling three-month basis, this is the highest ratio we have witnessed since the Financial Crisis.

To us at RSW, this shift in the pricing of risk is important to note as it marks a reversal of the "no risk is too big" mentality.

Extra Time: Credit Cards and Auto Loans

Credit Cards: If the economy is on solid footing with wages rising and unemployment at 3.50%, then why are consumers having trouble paying off their obligations?

- Credit card debt now exceeds $1 trillion, eclipsing the highs set in 2008 (*source: FRED*).
- Credit card rates stand at all time highs (*source: FRED*).
- Delinquencies across all banks are at four-year highs (Credit card balances are considered delinquent when they are 30 days or more past due) (*source: FRED*).
- At the 5,000 smallest banks (greater exposure to sub-prime or riskier borrowers) credit card delinquencies are hitting new all-time highs. (*source: FRED*)

Auto Loans: Is this really happening in the auto sector during a time of relative prosperity?

- According to the *Financial Times*, the global car market is shrinking faster in 2019 than at the height of the financial crisis.
- Car manufacturers are expected to eliminate 88,000 jobs in 2019 according to Bloomberg.
- In the third quarter, auto loans that were delinquent for 90 days or more reached $62 billion, a 19-year high.
- Roughly 20% of all sub-prime loans are delinquent.

No Time Out for Injuries

Not only did the Fed gurus hike the level of overnight funds 9 times since 2015, but they simultaneously employed another form of monetary brake known as QT (Quantitative Tightening). This was a reversal of their QE (Quantitative Easing) program where they ramped up the Fed's balance sheet to over $4.5 trillion by purchasing Treasury and Mortgage bonds in the open market. In the QT financial experiment, while not an active seller of bonds, the Fed allowed $50 billion ($30 billion Treasury, $20 billion mortgage bonds) of holdings to mature from their balance sheet without reinvesting the proceeds in newly issued government obligations.

In essence, this increased the "net" new supply of government bonds in the marketplace as a large purchaser (The Federal Reserve) backed away from the market. Here's the "kicker", the Fed's misguided decisions were compounded further as the federal budget deficit topped $1 trillion, up sharply from 2018's level of $779 billion. With the spike in Treasury bond issuance needed to finance the widening deficit, the banks and broker/dealer community were drowning in a sea of government debt as the supply exceeded demand. This abruptly caused the yield on 10-year U.S. Treasury notes to rise from the September low of 1.41% to today's high yield of a 1.95%.

Yellow Card

Over the last several months you have probably read articles or heard chatter about the events that are unfolding in the Repo market. While a complex issue, we will do our best to touch on the most important elements, as this situation supports the premise for RSW's 2020 forecast.

Repurchase Agreements (Repos) provide an overnight source of funding which is crucial for the financial system. In this method of banking, borrowers pay a specified interest rate and use their holdings of Treasury securities as collateral for the loan.

On September 17, 2019, for the first time in nearly a decade, the Federal Reserve had to intervene in the Repo market and provide vast amounts of liquidity to the banks. One of the underlying causes of this scarcity of reserves was the result of a large U.S. Treasury bond auction which dwarfed the amount of bank reserves. This caused Repo rates to spike because a large share of the newly issued bonds was purchased by securities dealers, who attempted to profit by selling the bonds to their customers. Rather than immediately pay for the bonds, dealers finance their bond inventories by using the securities as collateral for overnight loans in the repo market. The major lenders of cash in that market include money market mutual funds and banks. Unfortunately, these institutions spent their own reserves to pay for their Treasury bond purchases. With the demand to obtain funds in the Repo market outstripping the supply, rates rose dramatically above the Fed's target range of 2% and reached a high on September 17 of nearly 10%. While many other reasons were hypothesized since September 17 for the events that unfolded, it is worth noting that the "crisis" has not dissipated.

Since September, the Fed has been busily adding reserves to the financial system. In addition, the Fed has recently communicated that they are set to flood the market with liquidity by pumping over $500 billion into the financial system over year-end. While some Federal Reserve members are downplaying the situation in the Repo market as temporary, we would argue that this predicament is symbolic of a structural issue. Namely, that liquidity providers have ramped up their use of leverage to a much greater extent than was previously thought by the Fed or market participants. This leaves them in a poor position to assume additional levels of risk.

Conclusion

- In RSWs Q1 2019 commentary we said: "Later this year, we believe the storm should emerge in plain view and show itself in the form of a massive deleveraging cycle".
- In RSWs Q2 2019 musing we said: "the dramatic rise in bond prices served to be an acknowledgement of a pending deleveraging cycle".
- Former Fed Chairman Alan Greenspan in a recent interview said, "No recession in the last half century, at least, began from a period of deleveraging." As you would have already guessed, we disagree with Mr. Greenspan.
- We believe that the economy is unusually sensitive to shocks that would cause a recession.
- The challenge is that while the Federal Reserve and the Global Central Bankers have been fighting deflation, they have created another problem called low rates.
- Low rates have caused a number of issues such as; encouraging excessive risk taking, banking issues, bloated debt levels and have exacerbated a pension crisis.
- As we have witnessed in the fall of this year, longer maturity bond yields can rise for reasons other than the prospect of robust economic activity and/or expected higher rates of inflation.
- With that said, as we have stated in the past, with growth likely to slow and recession risks rising, it is more likely that the late-cycle environment will continue to support bond prices in 2020.

<u>Scoring our 2019 Prognostications:</u>

Interest Rates: 3.25% should cap any upward rate movements.
The 10-year U.S. Treasury bond yield topped out at 3.24%. With that said, at the onset of the year, we certainly did not envision a yield decline to 1.41%.

GDP Forecast: 2.00%
Actual: 2.18% (assuming a 1.50% average economist estimate for Q4 2019)

Inflation: 1.40°/ (as measured by the Core Personal Expenditures Index; CPE)
Actual: 1.70%

<u>Looking Ahead to 2020. Our Forecast is as Follows:</u>

Interest Rates: Using the US 10-Year Treasury bond as a proxy, yields should fluctuate in a wide range from 1.50% and 2.50%. To maintain a ceiling on yields, the Fed will likely implement QE4 in the second half of the year.

GDP Forecast: 1.25%
A recession is likely to begin in Q4.

Inflation: 1.50°/ (as measured by the Core Personal Expenditures Index; CPE)

Municipal Bond Commentary

Municipal bond prices increased considerably in 2019 as "AAA"-rated yields declined by an average of 90 basis points during the year. The yield differential between short and longer-dated securities compressed during the first three quarters to historically "flat" levels. For example, the "spread" between 2 and 10-yr tax-exempt bonds declined to just 18 basis points in September.

During the fourth quarter, the municipal market has continued to adjust to a more dovish FOMC, who cut the target rate for Federal Funds three times in 2019 to 1.50-1.75%. As a result, the 2's/10's muni spread has since increased from 18 to 37 basis points.

Tax-exempt investors poured an unprecedented $85.7 billion into mutual funds during the year which helped to drive the relative value of municipals versus U.S. Treasuries higher. The ratio of 10-yr "AAA"- rated bonds versus 10-yr U.S. Treasuries declined from 84.9% to 79.2% during the year.

Municipal issuance exceeded $410 billion, an over 20% YOY increase from 2018. A large portion of the increase came from taxable municipal bonds, as issuers used taxable debt as an alternative to "advance refund" outstanding issues carrying higher borrowing costs.

At this juncture, we strongly believe that a more defensive portfolio positioning is warranted. With tax-exempt yields being close to their historic lows, relatively flat slope of the municipal bond yield curve, systemic risks rising and the municipal bond asset class priced at "expensive" levels vis-à-vis the U.S. Treasury bond market, patience is required. To that end, we are maintaining a risk profile that is among the most conservative since our firm was founded in 2005. We believe that the yield curve will likely steepen in 2020. This should allow us to enhance the yield of our client accounts by exchanging a portion of our shorter call/maturity holdings for longer call/maturity positions.

Robert S. Waas Chief Executive Officer / Chief Investment Officer	Matthew T. Werner Senior Portfolio Manager	Mark J. Tenenhaus Director of Municipal Research	Mark A. Scott Senior Trader	Randy J. Fox Assistant Portfolio Manager	Andrew C. DeVivio Credit Analyst	Marites V. Pasturan Compliance Officer	Jeffrey S. Thompson Investment Reporting Analyst	James D. Thompson Client Service Associate	Mary Chris Ong Trade Operations Associate