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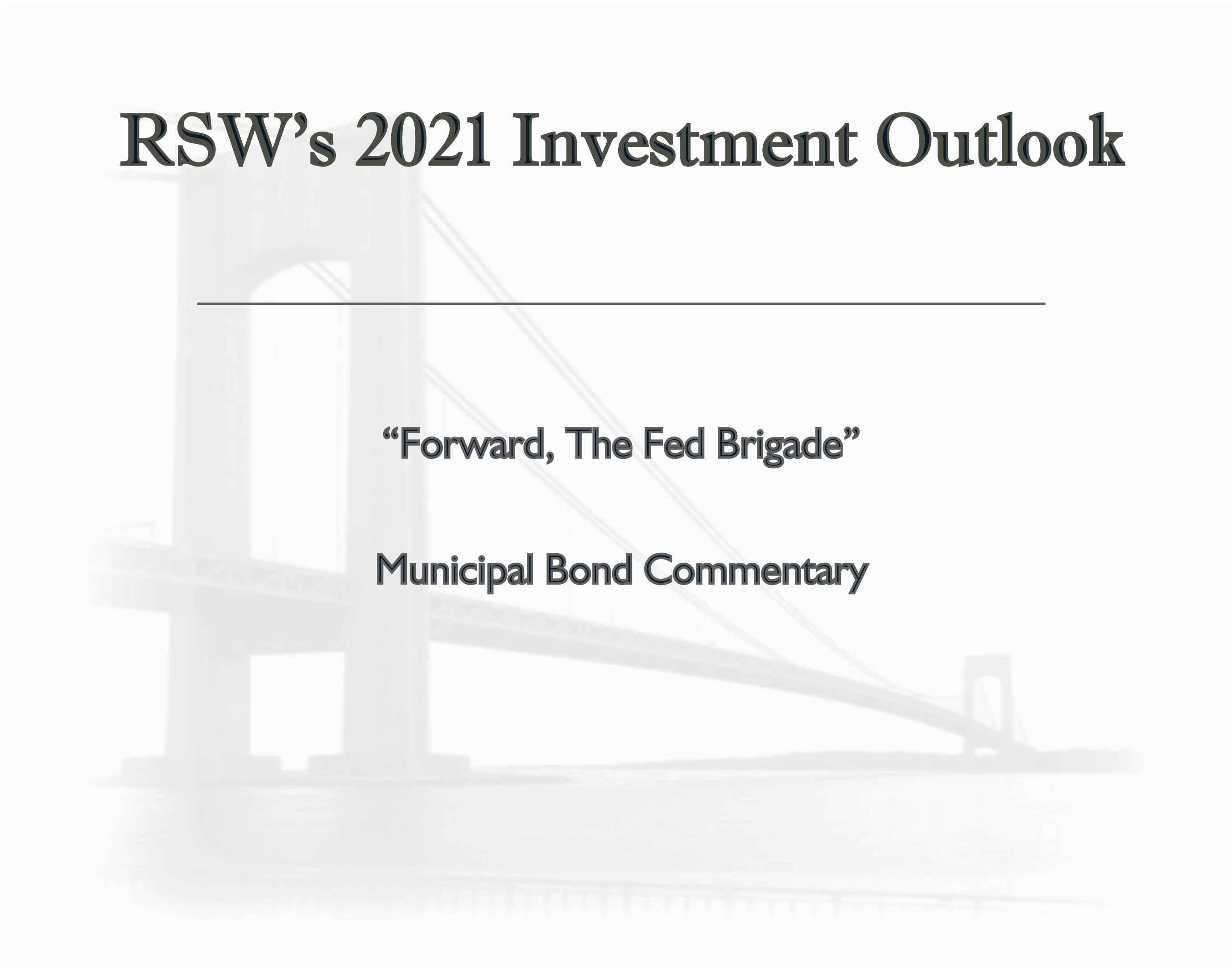

RSW's 2021 Investment Outlook

"Forward, The Fed Brigade"

Municipal Bond Commentary

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RSW INVESTMENTS

Forward, the Fed Brigade (1/4/21)

Year in Review

The world changed dramatically in 2020. As we move into the new year, what remains is substantial uncertainty about the impact of the Coronavirus on people's lives and livelihoods. Plain and simple, this was one of the most tumultuous years in modern history. While it's one that we would like to forgo reexamining, it is necessary for us to digress before we can prognosticate about 2021.

"Was There a Man Dismayed"?

To curb the Coronavirus pandemic, public health officials engineered the most abrupt economic collapse in our nation's history. This crisis dwarfed the economic suffering of the 2008 Great Recession as a far wider swath of the economy was shuttered to prevent the spread of the virus. Businesses, along with state and local governments of all sizes, struggled to fund payroll, pay bills and service their debts, sparking fears of a Deflationary Depression.

In response to the calamity, the Federal Reserve pushed short-term interest rates to near zero and ramped-up their monthly purchases of Treasury and mortgage-backed securities totaling $120 billion; $80 billion and $40 billion, respectively [1]. In addition, under Chairman Powell's leadership, the Federal Reserve sailed into uncharted waters and flooded the world with U.S. dollar liquidity by embarking on numerous unprecedented monetary policy experiments. These trials included the creation of emergency lending facilities, established to fund the Fed's first-time purchase of corporate bonds and provide loans and loan guarantees to municipalities.

As the economy and the pace of inflation swooned during the early stages of the pandemic, Congress passed the largest U.S. economic rescue package in history. Among the provisions, the $2.2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act provided relief for small businesses, funding for hospitals, support for individual incomes and financial aid for state and local governments. To further support the economy, deficit spending tripled last year's pace as U.S. government spending exceeded revenues by $3.1 trillion [2].

The aggressive expansion of monetary and fiscal policy generated a meteoric rise in economic activity and asset prices. However, because of a spiking U.S. current-account deficit and a Federal Reserve that is wedded to keeping rates near zero, the incentive to hold dollars was diminished. With the dollar tumbling versus the world's major currencies, the pace of domestic inflation has been escalating. Simply put, a weaker U.S. dollar has a pocketbook effect on U.S. citizens, as it now takes a greater amount of dollars to purchase products traded globally, such as food and oil. Conversely, the weaker dollar allows global and emerging market economies to produce "cheaper" exports which further contributes to rising inflation expectations.

[1] Data Source: Bloomberg, dated 1/4/2021
[2] Data Source: Bloomberg, dated 1/4/2021

Expectations for higher rates of inflation have not yet caused market participants to ramp-up their "bets" on a series of Federal Reserve rate hikes. Especially when you consider that the Fed's policies that are not "bond friendly". To wit, the Fed recently pledged to keep borrowing costs near zero for at least the next three years. Furthermore, they are seeking to maintain their purchases of Treasury and Mortgage debt at the current pace of $120 billion a month until the rate of inflation is sustainably above 2%. This tolerance for allowing higher levels of inflation is a significant policy shift, especially since "real" 10-yr U.S. Treasury yields are negative. With a nominal 10-yr yield of roughly 0.95% and year-over-year core Personal Consumption Expenditures (PCE) at 1.40%, the spread over inflation (-0.45%) is near the most negative on record [3].

Looking ahead to 2021

The outlook for economic activity and financial markets hinges on the interplay between three variables: the future path of Covid-19, the economic cycle, and Washington's response to these phases.

An increase in Covid-19 hospitalizations and new restrictions on businesses have exerted downward pressure on commerce. Amidst a renewed downturn in economic activity, the disparity between those thriving and those who are barely surviving has become even more obvious. This crisis put additional pressure on U.S. policymakers to approve another Covid-19 relief package in late December, this time for $900 billion [4].

In our opinion, these blockbuster stimulus bills are not likely to end soon. While over time mass vaccination could end the pandemic itself, we would not expect the vaccine to provide immunity against lasting economic damage. With government officials reading the same tea leaves, they are not likely to stop their attempt to levitate the economy by using a "kitchen sink approach".

***More* Reinforcements**

With Washington continuing its full-throttled emergency response to the pandemic, over the near term we would not bet against their ability to foster greater levels of growth. To us at RSW, one thing is for certain: "More" is on the way!

- ✓ More Congressional approved fiscal stimulus
- ✓ More Federal Reserve purchases of Treasury and mortgage-backed bonds, via Quantitative easing
- ✓ More deficit spending, leading to increases in the levels of new issuance of U.S. Treasury bonds
- ✓ More zero percent short-term interest rate policies until at least 2023
- ✓ More tolerance for higher levels of inflation
- ✓ More acceptance for a weaker U.S. Dollar

Over the coming months, do any of the above government policies seem like they won't lead to stronger economic activity, greater levels of inflation and higher long-term bond yields?

[3] Data Source: Bloomberg, dated 1/4/2021; Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services

[4] Data Source: Bloomberg, dated 1/4/2021

Competing Forces

With the above being said, 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. Our prognostication dating back to 2006 remains in force. Namely, that deflationary forces have already taken root, with 54 million of our population now aged 65 and over [5]. This cohort is increasingly dependent on governmental assistance programs such as retirement benefits and health care plans.

With a birth rate that is declining and life expectancy rising, a younger, smaller segment of our society is expected to shoulder the growing cost of the aged. Given the combination of a shrinking tax base, growing governmental expenses and burgeoning debt, taxes must rise to fund these outlays. This escalating burden siphons money away from investment and discretionary spending. Hence, sustainable strong economic growth and sustainable periods of inflation are extinguished.

Many casual investors believe that if the Federal Reserve maintains a zero percent overnight rate policy that market yields for bonds of all maturities will remain "well behaved". Well, fasten your safety belt because history shows scant evidence of that. In fact, we only need to look back to the last episode of extraordinary Washington intervention. As you may recall, on December 16, 2008 the Fed cut its key lending rate to zero and maintained that policy until December 7, 2015. During that seven-year period, yields on 10-year U.S. Treasury bonds fluctuated in a range between 1.39% and 3.99% [6].

Excerpts from RSW's 2020 Outlook

Do you recall the hysteria surrounding the inverted yield curve?

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 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.

In fact, we believe that the recent optimism is misplaced and that a financial event could be unfolding.

[5] Data Source: United States Census Bureau
[6] Data Source: Bloomberg, dated 1/4/2021

2020 Forecasts

- *Using the U.S. 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.*
- *A recession is likely to begin in Q4.*

2021 Prognostications

- *Interest Rates: 10-year U.S. Treasury bond yields should rise from the current level of 0.95% to 1.75% in the first half of the year, followed by a decline to 1.25% by year end.*
- *GDP: Against a backdrop of massive stimulus, 4% for the first half of the year, followed by a slowdown to a pace of 1.75% for the last two quarters.*
- *Inflation: average annual rate of 2%.*

Municipal Bond Market …Summing Up

During the early stages of the pandemic, the municipal bond market experienced significant stress. This triggered yields to soar as municipal bond bankruptcy concerns prompted individuals to rapidly redeem their holdings of mutual funds. This "dash for cash" caused the price difference between the "bid" and "ask" to expand to unprecedented levels. With the passage of the CARES Act and Chairman Powell announcing that the Federal Reserve could purchase tax-exempt debt obligations and extend loans to municipalities, municipal bond prices rebounded precipitously.

Today, despite elevated amounts of new offerings of municipal bonds, yields for most issuers have fallen below pre-pandemic levels as investor demand remains robust. However, across many sectors, financial conditions remain strained, especially when compared to the start of 2020. Despite the rollout of a vaccine, the future path of the pandemic and its continued impact on the economic recovery remains a "wildcard".

While we remain confident that the government response to this ongoing crisis will continue to be massive, monies received from Washington should be a "one-shot" and not a permanent fix to revenue losses. Municipal employee layoffs are expected to become permanent as jurisdictions will have little choice but to implement more permanent cost reductions. Unfortunately, this process of reorienting budgets with the "new reality" will be painful, especially for entities in the health care sector and those heavily reliant on tourism and travel.

Although we are not deluding ourselves into thinking that today's environment is in any way "normal", we have always and continue to maintain the belief that the risk of high-quality borrowers (such as those in which RSW invests) defaulting on their debt is overblown. However, it is incumbent upon us to remain even more vigilant today. These views are certainly reflected in our approach to the markets and as you would expect in the positioning of our client portfolios. As such, we aim to maintain a very defensive portfolio positioning as it relates to both interest rate and credit risk. Almost universally, the interest rate sensitivity of our client portfolios is at or near the lowest levels that we have maintained since we opened our doors in 2005.

Although we have been very early in our call for higher rates, we remain steadfast in our view that yields will not "hold" these extraordinarily low levels. We continue to be positioned accordingly and look forward to the opportunity to capitalize on the cyclical period of rising rates that should lie ahead. Exchanging cash or "near cash" (bonds with short maturity and/or call dates) securities for longer maturity bonds at a more advantageous time will boost the earnings stream of our client portfolios. Should any meaningful changes occur in the municipal bond market or our outlook, we look forward to communicating our views in a timely manner.

As always, thank you for your continued confidence in managing your assets and wish everyone the best of health and success.

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