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RSW's 2022 Investment Outlook

"The Tortoise and the Snail"

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The Tortoise and the Snail

2021 Year in Review

Before examining some of this year's events, it is incumbent upon us to hold ourselves accountable by reviewing 2021's forecasts versus the actual data. Please see below:

- RSW projected that 10-year U.S. Treasury yields would rise from 92 basis points to reach 1.75%, then decline to 1.25% by year end…… (while this projection looks spot on as the 10-year topped out at 1.75% and yields stand at 1.45% today, in the first quarter we did raise our year-end target to 2%)

- Furthermore, we envisioned that municipal bond yields would move in lockstep with the U.S. Treasury bond market, but tax-free bond yields only rose by roughly one-half as much.

- RSW projected GDP to be 4% for the first half of the year followed by 1.75% for the last 2 quarters. This forecast was scrubbed in RSW's Q1 commentary as we believed that inflation would become more firmly embedded in the economy.

- RSW's thought process was that the Consumer Price Index (CPI) would rise in the first two quarters followed by a decline in the last two quarters, averaging a rate of 2%. This forecast was scrubbed in RSW's Q1 commentary as we believed that inflation would become more firmly embedded in the economy.

Broad Summary

This was an unusually difficult year for fixed income investors as portfolio returns were primarily weighed down by inflationary concerns. Interestingly though, while the pace of inflation tended to worsen each month, 10-year U.S. Treasury bond yields peaked in the first quarter at 1.75%, long before the nearly four-decade high Consumer Price Index (CPI) print in December of 6.80%. After that sizable upward yield adjustment witnessed in the first three months, interest rates chopped around in a fairly narrow range for the balance of the year.

Snails Aren't Exciting

Compared to the U.S. Treasury bond market, the interest rate fluctuations in the municipal bond arena occurred at a "snail's pace". Investors poured a record amount of cash into the asset class with year-to-date mutual fund flows totaling roughly $100 billion, which served to buffer price declines. While it has been quite common for the municipal bond asset class to fare relatively well in a rising rate environment, the degree of outperformance during the year was stunning. For example, during the yield surge in the first quarter, 10-year maturity "AAA"-rated municipal bond yields only rose one-half as much as their U.S. Treasury counterparts. For the remaining 9 months of the year, tax-exempt yields were mostly steady and confined to a tight range, which produced scant portfolio management opportunities.

Throughout 2021, financial market participants were immersed in handicapping the Federal Reserve's likely response to the sizzling pace of inflation. To this end, many articles and conversations were also had debating the word "*Transitory*". As you may recall, as the year began, Federal Reserve Chairman Powell had maintained that any rise in consumer prices would most likely be transitory and, therefore, not require an immediate policy reaction from the Federal Open Market Committee (FOMC). The bond market, in general, has extended credibility to the Fed's position, even as inflation readings reached multi-decade highs.

Simply put, the foundation of the "transitory" argument is that the economic environment won't change price setting or wage setting behavior. As far as price setting is concerned, most companies have been willing and able to pass through higher price adjustments and are continuing to do so. When exploring wage setting behavior, here too we find nothing that is temporary. Employees have been emboldened to ask for higher pay and others are choosing to leave their post in search of higher salaries.

Behold the Turtle

Since March of 2020, the Federal Reserve, through a Quantitative Easing Program ("QE") has been injecting $120 billion monthly into the financial system through purchases of U.S. Treasury bonds ($80 billion) and Mortgage-Backed bonds ($40 billion). This "Emergency" level of financial experimentation was in addition to a Federal Funds rate that was slashed to zero percent. Recently, the Federal Reserve acknowledged that their monetary policies contributed to the "juicing" of the rate of inflation by providing too much liquidity to the financial system for far too long. As a nod to their policy error, Powell retired the word transitory (good riddance!) and announced a plan to end their bond purchases (QE) by mid-2022.

"There is a fine line between the perseverance of the courageous tortoise and the habit of the stubborn donkey." - Jonathan Lockwood Huie

2022 Outlook: Where Does All of This Leave Us?

As we outlined in RSW's 2021 Outlook, extraordinary monetary and fiscal policies should provide a healthy tailwind to propel economic activity, the pace of inflation and interest rates higher. Today, from where we sit, not much has changed. In fact, during March of this year we raised our forecast, calling for even higher yields, (+/-2.00% 10-year U.S. Treasury). While the upside momentum to rates may have temporarily stalled and our original timeline prolonged, our logic and therefore our forecast for higher rates over the near-to-intermediate term remains intact.

To be sure, there are a wealth of considerations affecting yields on bonds with differing maturity dates, all of which are based on forecasts of future events. In checking our beliefs, it is helpful for us to have a better understanding of what assumptions are being priced-in to market rates at any given time. The answer will aid us in understanding when the impetus for higher bond yields is over for this cycle or just taking a time out.

Currently, fixed income participants are becoming more obsessed with the Federal Reserve's eventual ending of QE, than the soaring levels of inflation. Investors and speculators are viewing the "taper" of bond purchases as the first step toward tighter monetary policy, which would likely usher in the next phase of the Federal Reserve restrictive monetary campaign, specifically, hiking short term interest rates. It is also safe to say that the market may also be pricing in a policy mistake whereby the Federal reserve "overtightens" thereby causing a recession.

While we agree with the market's overall assessment that future Federal Reserve actions should result in a policy misstep, it's too early to prepay for the possibility that yields will decline by purchasing highly interest rate sensitive bonds today. Let's remember that longer-maturity bond yields typically do not stabilize until the Federal Reserve is well through their rate hike campaign. This occurs as the economy is projected to slow on the back of tighter monetary policy. Since the Fed has not yet started to even lift short term rates, this stall in market yield movement should prove to be premature.

With that said, once the Fed goes into motion and begins to hike rates, longer-maturity bond yields should rise as well. This is the part of the cycle that we are patiently awaiting and believe that the next rate hike campaign should be a relatively swift one. As we have observed in past sequences, the combination of an upward correction in interest rates and the skyrocketing cost of essential items, siphons money from household budgets. These forces, as we have witnessed over the years, should serve as a self-breaking mechanism as they exert downward pressure on economic growth and therefore interest rates.

In fact, we project that the combination of higher rates and surging inflation should provide the impetus for a consumer led spending retrenchment in the latter part of the year. A Federal Reserve misstep should only hasten this outcome, especially if the history of the Fed holds true to form and they overreact to yesterday's news by slamming on the monetary brakes. Traditionally, by paying too much attention to today's economic data the Fed misses the turns, "overtightens", and cause the next recession. We firmly believe this pattern will unfold yet again, thereby causing economic growth to turn negative in the second half of the year. As is typical, longer maturity bond yields should begin their descent (prices rise) ahead of the worst of the economic data.

The Shell Has Been Reinforced

In these uncertain times, municipal bonds have remained a relatively safe asset class. Despite a challenging period where bond prices are declining, the volatility in the municipal bond market should remain muted.

At the onset of the pandemic there were misplaced fears of widespread municipal defaults which wreaked havoc on municipal bond prices. In response to the panic, the federal government stepped-in with a series of actions to provide financial support to municipalities. Highlights include:

- Billions of dollars in COVID related funding were granted to qualifying households with respect to employment benefits and to small businesses to provide further relief.
- Most importantly, state and local governments received trillions of dollars which included significant amounts not "earmarked" and therefore "essentially free cash".

With trillions of cash remaining in state coffers, it is highly unlikely that another episodic event over the next 24-month period will cause budgetary pressures or credit fears of such in the municipal bond market. In addition, with the Federal Government understanding the importance of a well-functioning municipal bond market, any needed support that should be needed to reinforce the "protective shell" should be swift and broad based.

Yes, the waiting game of earning negligible returns is painful and most fixed income investors do not cheer a rising rate environment. However, with our active portfolio management style being conservatively positioned, portfolio market value fluctuations can be lessened, and assets can be shifted to earn higher levels of tax-exempt cash flow over time.

While we are restless and eager to earn a modest amount of additional income today by taking on greater levels of interest rate risk, we must continue to resist that urge. It is classic that these feelings are heightened in an environment where complacency reigns contributing to a frantic search for yield mentality.

Conclusion

The Turtles are Out of Their Shells?

We expect another move up in bond yields in 2022, as globally, central bankers reverse course and install tight monetary tactics away from "emergency" funding levels initiated over the past several years. We patiently await the increased level of interest rate variability that should emerge from such a reversal of monetary authority policies. So, with a defensive positioning in hand, we patiently await the next opportunity to extend our average maturity and duration (measure of interest rate sensitivity), in the spirit of enhancing overall portfolio income levels and the increased prospects for capital appreciation.

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