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Intra-Quarterly Commentary

“The Long Awaited Shift to Higher Rates is Upon Us”

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The Long-Awaited Shift to Higher Rates is Upon Us

Since December 2020, RSW has held the view that extraordinary monetary and fiscal policies should propel economic activity, the pace of inflation, and therefore interest rates higher.

Having held this opinion, RSW's client portfolios have been conservatively positioned to lessen the degree of market value fluctuations.

While there has been a remarkable number of fits and starts over the last 14 months, rates have trended higher, as 5-year U.S. Treasury bond yields have risen from 36 basis points to 1.63%. Concurrently, 10-year U.S. Treasury bond yields have climbed from 92 basis points to today's level of 1.80%.

For much of this period, tax-free rates were hesitant to advance, increasing approximately one-half of the pace of U.S. Treasury debt.

During January of this year, however, the streak of municipal bond outperformance came to an end with 10-year "AAA" rated tax-free bond rates accelerating by 52 basis points.

Rising tax-exempt yields have put downward pressure on the performance of all high-quality bond portfolios, including those that are “buy and hold”.

By maintaining relatively low levels of duration (measure of interest rate sensitivity), we have been well positioned to capitalize on this higher rate environment.

While a rising rate period can be unsettling for investors, it is exactly at times like these where RSW’s active strategy can "pay dividends".

Today, we are slowly and methodically reducing our defensive portfolio structure. While we remain patient, the process of exchanging cash and shorter call date/maturity bonds for higher yielding, longer call date/maturity bonds has begun.

It is common during periods like these where less sophisticated municipal bond mutual fund investors seek to redeem their holdings. Should we encounter an environment where FOMO (Fear of Missing Out) turns into FONGO (Fear of Not Getting Out), we are well positioned to acquire bonds at heavily discounted prices.

Should such an opportunity arise, we know from experience that these periods of dislocation could be short lived or become extended. At this juncture, we are respectful of either possibility. Therefore, during periods of price weakness, a gradual approach will be utilized to increase our levels of interest rate positioning back to "neutral". In addition, if all goes according to plan, we envision an upward lurch higher in rates that should warrant a reallocation to above average levels of duration.

Looking Ahead

Our forecast from RSW's 2022 Outlook remains in force. Namely: "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, "over tightens", 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."

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