



The Time is Now (5/16/2018)

With an assist from our friends at Goldman Sachs we are ready to release RSW's third "strong buy" recommendation in 13 years. Clients have contacted us regarding an article published by CNBC which reflected the opinions from Goldman Sachs titled: "Something strange is happening with the US economy that could cause interest rates to jump".

Succinctly put, the article outlined the following:

- An unusual phenomenon is occurring in that the Federal Budget deficit is increasing as the unemployment rate is declining. (typically not an inverse relationship)
- The deficit is expanding due to greater levels of fiscal stimulus (Tax Cuts & \$1.3 trillion Omnibus Spending Bill)
- Government will need to issue greater amounts of U.S. Treasury bonds to fund the deficit which will send yields higher as supply outpaces demand
- Goldman predicts that the benchmark 10-year US Treasury note yield could rise to 3.60% by the end of 2019 (Note: should their forecast prove to be accurate, our models predict that even with a roughly 50 basis point rise over that time period, our Market Duration strategy should produce a gross total rate of return of around 2.56%).

We believe that the views from Goldman reflected in this article are only looking at one side of the conversation. Specifically, they believe that the economy will grow like gangbusters despite rising interest rates resulting from an exploding deficit and a related flood of new Treasury bond issuance. At RSW, we believe higher levels of growth with a resultant spike in interest rates cannot co-exist. Not with an economy that is this highly leveraged.

To provide some context to this belief, please see the following which is an excerpt from RSW's Q2 2017 commentary: "The decade's long trend to lower rates has encouraged complacency about mushrooming debt. For example, if you borrow \$1,000 at 4% and the rate declines to 2%, your debt servicing costs (interest expense) are \$20. If you double your loan to \$2,000 and rates rise from 2% back to 4% the debt service is \$80 or 4X".

Furthermore, in the U.S. we have doubled our national debt from \$10 trillion to \$20 trillion with an approximate five-year average maturity. In 2013, the amount of domestic corporate debt issued increased roughly 40% over its 10-year average (\$1.4 trillion versus \$1 trillion). With rates so low, who can fault corporations for borrowing money basically for free? However, for corporations and investors to assume that yields will stay at those low levels when they need to "roll over" this debt in 5 years is a huge bet and perhaps reckless. Why will the pain be so great? In 2013, the yield on 5-year U.S. Treasury Notes was just 65 basis points (0.65%) it is now yielding 2.92%. This is an increase of 227 bps or 349%. Risk happens fast and so does debt service.



Finally, with 10-year U.S. Treasury yields now sitting at 3.10%, bond traders and investors are beginning to panic. It is exactly at times like these when RSW's methodical and disciplined approach of extending average maturity and/or duration (where applicable) should pay dividends. Again, a statement like this has only come from RSW two other times in our 13-year history (2008 & 2010's Meredith Whitney debacle). We believe the opportunity is now.

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 Junior Credit Analyst	Alec K. DeWitt Product Specialist	Marites V. Pasturan Compliance Officer	Jeffrey S. Thompson Client Service Associate	James D. Thompson Client Service Associate	Mary Chris Ong Trade Operations Associate
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