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# RSW's Q1 2024
# Fixed Income Newsletter

## How Long Can the Conductor Pull the Train?

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## How Long Can the Conductor Pull the Train?

Despite one of the Federal Reserve's most aggressive rate hike campaigns on record, a consistent pace of economic activity continues to challenge RSW's forecast for a recession. Fed Chairman Powell's forceful interest rate policy has been counteracted by a nearly unprecedented amount of deficit spending that has stabilized our nations' growth rate. Of course, however, this strategy comes at a price.

Since 2021, including the COVID-19 relief monies, U.S. debt has increased by over $6 trillion. This year alone, by borrowing monies to cover a shortfall between federal expenditures and tax collections, the projected gap is anticipated to add another $1.6 trillion to our homeland's red ink. While today's annual shortfall is unsettling, the Congressional Budget Office (CBO), is forecasting that annual deficits will rise to $2.6 trillion over the next 10 years.

To put these figures into perspective, as a percentage of estimated GDP, the budget gap is expected to become 50 percent larger than the historical average of the last 50 years (Bloomberg). Interest expense, expected to top $1 trillion annually (Bloomberg) and on a bloated amount of U.S. Treasury debt, is a key driver of this ugly predicament. The question that remains, however, is whether and for how long elected officials can rack-up debt to produce positive economic energy?

**The steel spikes securing the rails are becoming loose.**

There are numerous indicators that economic activity is losing momentum. For one, the ***employment*** statistics should not be communicated as a cock-and-bull story, but instead be firmly rooted in reality. Here comes a dose! The data enclosed in the Bureau of Labor Statistics March employment report conveys a less optimistic tale than the media headline: "The economy added 275,000 during the month of February". While the pronouncement is impressive, it does not distinguish between part-time and full-time positions, nor speak to the quality and economic sector of those jobs.

The reality is that in the preceding three-month period, employed persons have fallen by 900,000, 1.8 million full-time jobs vanished, and that 8.7 million people now hold multiple jobs (Federal Reserve of St. Louis). In addition, during February, roughly 19% of the jobs created were due to government hiring. This taxpayer funded activity continues to be a growing share of the employed.

Next, ***Retail Sales****.* Here too, the headline figures mask a darker reality, as the elevated pace of inflation is boosting the dollar value of sales. Think about it! Retail sales statistics are compiled using the actual prices paid for goods and services. Thus, if the price of goods increases but the number of units sold are unchanged from the prior reporting period, the dollar amount of retail sales would still be increasing.

So, while some economists and media members may celebrate a growing retail sales report, one must determine if the increase is due to higher prices and/or an increase in the volume of goods sold.

Unfortunately, since July 2021, if inflation was removed from the "retail and food service" index, it would show virtually no growth in the number of units being sold.

The ***Leading Economic Indicators*** (LEI)** also support the view that the "soft landing" (economy avoids a recession and inflation returns to normal) tale will prove to be just that, a delightful narrative! Except for last month's reading of +0.1%, for nearly two years, the LEI has posted a negative reading, suggesting that a recession is likely (FRED).

*** The LEI is comprised of ten indicators that are designed to provide an indication of U.S. economic health and signal changes in the business cycle.*

Alternatively, headlines portending economic Gloom and Doom are likewise prone to be misleading. For example, a year ago, Reuters penned an article titled: "U.S. ***money supply*** falling at fastest rate since 1930's". While this post may have frightened casual investors, the details as always are crucial. While M2* has steadily declined from its April 2022 peak, some perspective is necessary as this shrinkage occurred after the largest monetary expansion in history.

As you may recall, M2* was powered by the Fed as they flooded the financial system with money to stem the effects of the COVID-19 pandemic. So, as Chairman Powell reversed course and started hiking rates in March 2022, it is no coincidence that these actions coincided with the peak level of cash in circulation and pace of Consumer Price Inflation (CPI).

Expressed another way, the amount of money supply rose 43% from pre-Covid sums to the April peak of $22 trillion and continues to slide to today's levels of $20.9 trillion (FRED). So, while the percentage decline (5%) may be the largest since the 1930's, there is the potential for a more significant retracement should the monetary base continue its reversion to the mean. Over time, should this occur, the rate of inflation should subside as well.

**M1 is cash, coins in circulation and checking accounts. Simply put, monies that are readily available and easy to access. M2 is M1 plus assets that take a greater effort to convert to "spendable cash" such as money market accounts CD's etc. (FRED)*

**Final Stop**

Since the Great Financial Crisis (GFC), Congress and the Federal Reserve have played the role of the conductor attempting to engineer a soft landing. To that end, those in Washington have attempted to thwart the contraction segment of a normal business cycle (expansion, peak, contraction, trough). A large contingency of policy makers believe that deficits don't matter and that there are no consequences for unrestrained spending.

Aside from the issues described above, there are many topics discussed in RSW's prior quarterly missives that should derail an arrival at the soft-landing destination. As a refresher, some prior themes include: an inverted yield curve, regional banking crisis, imploding commercial real estate market, inflation that hit 40-year highs, soaring interest rates, rising levels of corporate bankruptcies and spiking levels of credit card delinquencies, are all byproducts of an overheated and overindebted economy.

Of course, those in Washington are in tune to the challenges discussed herein, but it is unlikely that a policy reversal will occur. At this juncture, the conductors know that if the deficit spending (coal) ceases, the train (economy) will stall and slide backwards. Simply put, elected and unelected officials cannot and have not risked this outcome: *"Due to budget cutbacks, the light at the end of the tunnel has been turned off". (Robert Townsend)*

**Municipal Commentary**

While all eyes remain focused on Fed Chairman Powell, the financial markets do not wait for the utterances of one man. Markets form expectations about future data/events and assess the probability of those occurrences. So, despite the Fed having put their interest rate policy on hold in the first quarter, 10-year U.S. Treasury bond yields have fluctuated between 3.88% and 4.33%. On a relative basis, "AAA" rated tax-exempt yields were fairly well grounded as they fluctuated by only 23 basis points between 2.28% and 2.51%.

The imbalance of demand versus the availability of bonds available for sale in both the new-issue and secondary market was the key story for the quarter. The amount of money being put back into investors hands and available for reinvestment due to high levels of coupon income, bonds being called, and maturing securities exceeded the availability of bonds for purchase. This disparity enabled tax-exempt bond prices to maintain a better level of price stability during the three-month period where interest rates rose modestly.

While we remain very constructive with respect to our interest rate forecast (10-year U.S. Treasury yield to breach 3.30% by year end), we paused our strategy of pushing the interest rate sensitivity (as measured by duration) of our client portfolios to higher levels. Our reasoning is as such. For one, it is still likely that yields in the U.S. Treasury bond market could experience some further upward movement. Secondly, given the "outperformance" of the municipal bond asset class, we believe that on a tactical basis, the market is expensive and should cheapen over the coming weeks. Thus, if either of those (or both) dynamics were to occur we would be presented with a superior opportunity to enhance the interest rate sensitivity and average earning yield (acquisition yield) of our client portfolios.

In terms of credit quality, we are certainly keeping a close eye on tax receipts as they have certainly slowed from the peak. Thus far, some of the weaker issuers (RSW typically avoids) are coming under budgetary pressure. Namely, health care related bonds and General Obligations (GO's) of the states of Illinois, California, Massachusetts, New York (very little General Obligation debt outstanding) and Minnesota. While our strategies routinely gravitate toward high-quality bonds, our forecast for continued economic weakness dictates that we maintain our tight standards and lend monies to only the most creditworthy borrowers.

Robert S. Waas
Chief Executive Officer/Chief Investment Officer

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