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RSW's 2024 Investment Outlook

"Eminence Front"

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"Eminence Front"

Eminence refers to dominance, power, and superiority. "Eminence Front" is the deception of such, whereby someone fabricates a persona to achieve their objectives. The term was coined by a rock band known as "The WHO" in 1982 and is a title track of a song written by Pete Townshend. According to Townshend, Eminence Front "explored the illusions, and delusions of wealth."

It appears that Federal Reserve Chairman Powell, the media, and many pundits have been actively engaged in their own style of trickery to mask the weaknesses in the foundation of the U.S. financial system and the pace of economic activity. Despite obvious signs of an impending recession and cracks in the banking system, we have been told repeatably that our nation's monetary health is in great shape.

"That Big Wheel Spins"

Their story was easy to spin. After all, the rate of unemployment remained near all-time lows, third quarter GDP accelerated at 5.2%, and corporate profits grew with robust persistence. Given this backdrop, one would think that the Fed would not be concerned with interest rates being too high. To that end, on December 1st, President of the New York Federal Reserve John Williams, and Vice Chair of a committee responsible for setting rates in the U.S., said that it is "premature" talk about rate cuts. That same day, Federal Reserve Chairman Powell said, "We are prepared to tighten policy further" if needed.

Just 12 days later, On December 13th, with Powell's tough talk in the rearview mirror, he delivered a divergent message predicting that the Federal Reserve would cut overnight rates three times for a total of 75 basis points. If that about face was not enough, on December 15th, New York Federal Reserve President John Williams was asked about the potential for interest rate cuts. He said that such talk is "premature" and that discussions about easing rates were not even being discussed.

Since RSW's founding nearly 19 years ago, we have been consistent that the Federal Reserve's messaging regarding interest rates is irrelevant. Ultimately, market participants determine where longer-maturity interest rates should be set. How many more rotations will "Fed Watchers" have to endure before they figure this out?

"It's a Put On"

When optimistic communications are crafted to protect the "everything is great" narrative, usually what's missing is the mention of debt. This omission is significant since debt has promoted the illusion of prosperity. While it may be possible to convince and delude top wage earners that the financial health of America's citizenry is on solid footing, good luck trying to convince society's most vulnerable of the same.

While a surging inflation rate affects everyone, those at the lower rungs of earning power are harmed disproportionately. Of particular importance is the period between April 2021 and May 2023 where real earnings (after inflation) declined unabated. In fact, during that period, the rate of inflation exceeded gains in take home pay by a cumulative amount of 51.3% (Source: Bloomberg). Unfortunately, for far too many that put the ability to afford what was previously affordable out of reach. Faced with this precarious position, the most financially challenged had no option but to draw down their savings and/or take on greater amounts of debt.

The data highlights this reality. According to the San Francisco Fed, from August 2021 to June 2023, Americans blew through nearly all their savings. Specifically, during this nearly two-year period, the aggregate amount of nest eggs fell from a peak of $2.1 trillion to $190 billion. As resources were being depleted, the tens of millions of Americans who struggled to pay their bills turned to borrowing money and did so at a break-neck pace.

- Credit card balances grew at an astonishing pace and stand at levels that are approximately 34% higher since the fall of 2021.
- Since the first quarter of 2022, the pace of delinquent credit card debt has risen by roughly 90%. (Source: Bloomberg).
- According to the Lending Club, approximately 62% of our country are now living paycheck to paycheck.
- JP Morgan projects that by the middle of 2024 “it is likely that only the top 1% of consumers by income will be better off than before the pandemic.”

To make matters worse, the lending practices of financial institutions have become more restrictive. Moreover, the percentage of domestic banks that are tightening lending standards for consumer loans (excluding credit card and auto loans) are making new cycle highs. This is sure to put pressure on those with little to no savings and highly elevated debt burdens. The question in front of us now is, how long can this environment persist before the Minsky Moment (please refer to RSW’s Q3 Commentary) is reached?

Rising debt levels are also a national problem, as the Federal Reserve jammed interest rates higher to battle rampant price inflation. The parabolic rise in rates, combined with a ballooning level of outstanding U.S. Treasury debt, pushed the annualized level of interest payments above $1 trillion in October (Source: Bloomberg). To put this interest cost into perspective, in November our nation shelled out $66 billion for national defense, and over $80 billion for interest expense on outstanding debt.

Trapped

Excessive national debt has unleashed a consequence known as the “Crowding Out Effect.” This occurs when government spending detracts from private sector investment and diminishes the consumer’s demand for goods and services. According to the Congressional Budget Office (CBO), we have already reached this inflection point!

As federal spending outpaces the level of tax revenues, the government has two options or a combination of both to bridge the shortfall: increase taxes on individuals and corporations and/or issue greater amounts of U.S. Treasury debt. At this juncture, however, either option should only serve to suppress economic activity. For example, higher taxes mean companies have fewer resources to invest in their business and individuals have less funds to allocate toward discretionary spending.

Likewise, if the government increases the amount of borrowing and the bonds are purchased by individuals and institutional investors, a lesser amount of capital is available to be spent in the private sector. Ultimately this detracts from economic activity. Likewise, if the pace of borrowing exceeds the level of demand for the debt offered for sale, interest rates could rise. This could discourage the private sector from paying higher interest rates, thereby discouraging new investments and spending.

Some economists may argue that the crowding-out theory is bogus and that more government spending leads to more private spending, thereby strengthening economic activity. We certainly agree that historically there have been periods where this desirous outcome has occurred over short periods of time. However, from here forward, given our nations bloated levels of debt and runaway budget deficits, further increases in government spending should only yield a slower U.S. growth rate.

Economic Conclusion

Politicians and "media experts" have sold the public an illusion that borrowing and spending trillions is a long-term solution to sustain and grow the U.S. economy. Against the backdrop highlighted above, we at RSW strongly disagree with the "soft landing" (low inflation and slow growth) narrative pushed by those with an agenda. It is likely that a severe recession coupled with a consequential financial event lies ahead. In the words of Pete Townshend, the illusion that everything is great is nothing more than an "Eminence Front."

2023 Interest Rate Review and 2024 Outlook

Ten-year U.S. Treasury Note yields opened the year at 3.87% and crested at 5.03% on October 19th. While it took approximately ten months for the market to travel 116 basis points, over the last two months virtually all the yield rise was retraced. Today, the ten-year U.S. Treasury Note yield stands at 3.89%.

Likewise, tax-exempt yields have fallen sharply as can be measured by "AAA" rated tax-exempt rates which have collapsed from 3.59 to 2.28%. While it could be said that this outsized downward shift in rates may be the entire move, it is likely to only be the beginning as we believe yields could fall by another 75 to 100 basis points in 2024.

With that said, given the speed of the recent decline, some upward yield retracement should be expected. We would view such a correction as exactly that! A correction within a bull market (declining rates/rising prices). Therefore, periods of price declines will be viewed by our team as an opportunity to further extend the duration (interest rate sensitivity) of our client portfolios to lock in relatively high yields and maximize price appreciation.

RSW's Credit Research

RSW's approach to managing credit risk has been consistent and unchanged since the founding of the firm. We seek to minimize risk by attempting to project events and trends that could result in near and intermediate term credit deterioration. This approach has allowed us to meet prior challenges head on, such as the stress of unfunded pension liabilities, the Great Recession, the bankruptcy of Puerto Rico, and of course the fallout of the COVID pandemic.

The challenge for 2024 will be to construct portfolios that are well positioned to meet the impending economic slowdown. To this extent investment selection will focus on state and local governments that have demonstrated a commitment to building reserves and buffers, post pandemic. We approach 2024 from a position of strength as 95% of our municipal holdings are either rated "AA" or "AAA".

Happy Holidays and best of health for the New Year! It is an absolute honor and privilege to be able to manage our clients hard earned assets through these challenging times. Thank you for affording us at RSW the opportunity to earn your continued trust and confidence.

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All performance referenced is historical and is no guarantee of future results.