June 28, 2023

RSW's Q2 2023 Fixed Income Newsletter

The Marathon of Waiting

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"In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could" (Rudiger Dornbusch, economist).

Akin to RSW's prior forecasts of significant economic and financial turning points, progress toward our prediction seems to be crawling at a snail's pace, testing our patience and beliefs, and challenging our expectations. Simply put, the prophecy for a significant weakening in economic activity accompanied by plunging interest rates has clearly been early.

The Great Financial Crisis of 2008 (most serious financial crisis since the 1929 Depression) serves as an example of "right, but early" (RSW) forecasting. Specifically, as stated in RSW's Q1 2007 commentary: "It is no longer out of place to fear both a financial event where securities and institutions of all kinds are affected, and an economic contraction caused by a severely damaged consumer."

Most recently, the same can be said when RSW forecasted a surge in the rate of inflation combined with soaring interest rates. Here too, while 2022 scored the worst year for the bond market in history, RSW started forecasting these events at the beginning of 2021. Specifically, in RSW's 2021 Investment Outlook: "Many casual investors believe that if the Federal Reserve maintains a zero percent overnight rate policy that market yields for bonds of all maturities will remain 'well behaved.' Well, fasten your safety belt because history shows scant evidence of that."

While we would prefer for RSW's timing of paradigm shifts to be "spot on," such occurrences can often be attributed, at least in part, to luck. To be frank, our chief concern when predicting extraordinary events is being too late. Such an occurrence would prevent us from realigning our client portfolios to capitalize on massive price shifts.

Powell's Endurance is Being Tested

In June, Federal Reserve Chairman Powell elected to leave rates unchanged. This, after a marathon of rate hikes that began in March of last year, lifted the Federal Funds Target Rate ten consecutive times and by a total of 500 basis points. By inflating the cost to borrow funds for individuals, businesses, and banks, Powell is aiming to reduce borrowing/spending activity and ultimately curb inflationary pressures.

However, early in the rate hike cycle, Powell encountered a familiar conundrum experienced by three former Federal Reserve Chairman, Paul Volker, Alan Greenspan, and Ben Bernanke. What do these Chairmen have in common? They all caused the yield curve to invert (short-term rates rose above longer-maturity debt). Since Powell's tightening cycle began in March 2022, short-term rates rose by 500 basis points and 10-year U.S. Treasury bond yields only rose by roughly 1/3 that amount. This dynamic has caused the yield of three-month U.S. Treasury Bills to exceed the yield on 10-year U.S. Treasury Notes by a whopping 160 basis points, a level of inversion not witnessed since 1981.

While the Fed can control short-term interest rates, it doesn't necessarily guarantee any rise or proportional increase in long-term interest rates. Longer-maturity rates are influenced by a variety of factors that include market expectations for inflation, global economic conditions, supply, and investor sentiment over a long-time horizon.

Just this year alone, despite Powell having raised short-term market rates by 75 basis points (3/4 of 1%), 10-year U.S. Treasury bond yields have remained largely unchanged. Given the bond market's expectation that each rate hike brings the economy closer to a recession, Chairman Powell's policies could be serving to anchor long-term rates thus providing

some form of monetary stimulus (described below) rather than a tightening of monetary conditions. With the Chairman's policies delivering inconsistent results, Powell elected not to continue his string of rate hikes in June.

Adrenaline Rush Hobbles the Start of the Recession

There are forces currently serving to provide a shot of adrenaline to economic activity. Namely, with mortgage rates closely tied to 10-year U.S. Treasury bond yields and the relative stability of those rates, activity in the single-family housing market has bounced off the bottom. In fact, the U.S. Homebuilder Sentiment Index is now near a one-year high.

Likewise, lower oil prices during the period also benefited consumers, as the cost at the pump fell, serving to boost discretionary spending. It is also expected that the U.S. will run a deficit of approximately two trillion dollars annually (Congressional Budget Office). This amount of deficit spending adds to our nation's growth rate and counteracts, to some degree, the monetary tightening initiated by the Federal Reserve.

These economically countervailing forces, among others, have stabilized the economy and altered the route to RSW's base case forecast. Over the coming months, it is likely that this episode of relative strength should become exhausted.

Credit is to the Economy as Hydration is to a Runner

With credit being the lifeblood of our economy, it is crucial to monitor the availability of borrowed monies and assess whether it is becoming constrained. As was stated in RSW's Q1 commentary, the availability of credit is becoming relatively scarce. The March banking crisis exacerbated a credit crunch where lenders have become more cautious in extending credit, tightened their lending standards, and have reduced the amount of credit they offer.

After you read below you should understand why this year's banking crisis did not "break the tape" but was just the equivalent of a runner experiencing pre-race jitters. 26.2 miles still lie directly ahead! To understand why, we need to understand some of the factors that drive banking decisions and yes, the inverted yield curve is a key component in a Savings and Loan bank's decision to extend loans:

- Profits: A bank's profitability is driven by its ability to earn income on the differential between the interest that is paid to depositors and the ability to lend to borrowers at long-term rates. An inverted yield curve diminishes this spread and hence the incentive to extend credit.

- Funding Challenges: When the yield curve is inverted, depositors may seek higher yielding short-term investments rather than maintain their monies in a lower yielding savings account. This further reduces the motivation to lend as their access to low-cost funding is diminished.

- Greater Risk: An environment where economic activity is expected to be weak, or contract, typically coincides with periods where the yield curve is inverted. As you would expect, these conditions lead banks to become more risk averse as the creditworthiness of its borrowers becomes less certain.

Aside from the obstacles highlighted above, collectively, regional banks could be experiencing a more extreme period of uncertainty than was witnessed during the Great Financial Crisis. With roughly 68% of all Commercial Real Estate (CRE) loans initiated by regional banks, price declines in this sector (namely office buildings) are presenting yet another considerable challenge for the regional banks. According to Moody's, this is the first time since 2011 that this sector has

experienced broad price declines and it appears that the decay is in the early stages. Furthermore, with the work from home trend enduring, the rating agency is forecasting that nearly one-third of office buildings in the top 80 metropolitan areas could be "obsolete."

It is likely that significant write-downs in the value of the commercial properties are in the offing. This could impair a bank's balance sheet, thereby impinging on its ability to extend new loans and worsening of an already challenging period to access credit.

Finish Line

Over the near term, although market yields could temporarily probe higher, we are still convinced that widespread financial and economic turmoil lies ahead accompanied by a dramatic decline in interest rates.

Municipal Bond Perspective

Tax-exempt bond prices experienced slight pressure during the quarter as they followed the direction of the U.S. Treasury bond market. Additionally, there were both positive and negative factors to consider, which ultimately had only a minor influence on prices.

To begin, while the FDIC does not typically engage in selling municipal bonds as part of its core functions, these securities were acquired as part of its efforts to manage and resolve failed banks. During the quarter, roughly $7 billion of tax-exempt bonds (versus a quarterly new issue calendar of approximately $72 billion, source: JP Morgan) were sold by the FDIC as part of their effort to recover funds. This added a "shadow" amount of supply to the marketplace, putting some upward pressure on yields as the bonds were "digested" by the broker/dealer community and investors.

On a positive note, the municipal bond arena entered a seasonal period where investors are becoming flush with cash as coupon payments, bond calls and maturing securities are elevated during the June through August months. This relative wall of cash should exceed the amount of anticipated new issue supply (source: JP Morgan) and should serve to enhance the performance of the asset class relative to U.S. Treasury debt obligations.

In terms of creditworthiness, state tax collection growth is showing signs of slowing. Nevertheless, growth for most states remains above historical averages. This slowdown, to a large degree, reflects the drawdown of "excess consumer savings" attributed to the various stimulus packages as well as higher interest rates. With the advent of a deep recession (RSW's base case) in the offing, tax receipts for most states should experience slower growth or even declines. This is already evident in New York and California.

However, most high-grade issuers are well prepared for this scenario. As the new fiscal year begins (July 1), state budgets, on average, have adopted conservative revenue estimates. Rainy Day Funds and various reserves are also at historical highs. Therefore, as was witnessed even during extreme circumstances, (i.e. 2008), we do not anticipate any significant negative credit pressures on our high-grade holdings in the foreseeable future. With that said, we will remain cautious and highly vigilant with respect to managing credit risk.

Enjoy the Summer!

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