October 2, 2023

RSW's Q3 2023
Fixed Income Newsletter

The Popeye Moment

The Popeye Moment

Popeye the Sailor Man was a fictional cartoon character who, when he reached his breaking point, would eat spinach to gain superhuman strength. At the moment of maximum pressure Popeye would say, "That's all I can stands, cause I can't stands no more." What is it that we can't stands no more? And how do we behave when our point of stressful urgency is reached, and we can't stands no more?

In RSW's first quarter of 2022 commentary we highlighted economist Hyman Minsky. He pontified that when a person feels that they will be partially indemnified from substantial loss when pursuing financial objectives, their risk tolerance increases. Said differently, as the mood of borrowers and speculators shifts from one of prudence to outright complacency, he further suggested that this behavior spurs decision-makers to deplete their liquidity positions, assume above-average debt loads, and shun safe assets in favor of riskier investments.

According to Minsky, extreme speculation will *eventually* lead to a crisis and the longer the periods of excesses last, the more acute the crisis. While history proves this thesis correct, *eventually* is not an acceptable time horizon to position one's investment portfolio. So how do you know when the maximum point of economic and market stress is being reached? In other words, "A Popeye Moment", when debtors, creditors, consumers, and investors are saying "that's all I can stands, cause I can't stands no more."

Who Needs Spinach?

If one were to review the "headline" data, one would assume that the economy is just fine. After all, the statistics most talked about by pundits are the pace of GDP (Gross Domestic Product) and the rate of unemployment. However, the steadiness in these fundamental economic measurements is masking the weakening underpinnings of our nation's financial health. Specifically, it is the "large" who are performing relatively well, compared to the "small/middle" who are reeling, and "can't stands no more." Evidence of this dichotomy of financial well-being include:

- Small-Cap versus Large-Cap

Despite the Federal Reserve hiking rates to their highest levels in 22 years, the amount of interest income that corporations are earning on their cash investments surprisingly exceeds the interest expense (also known as "net interest") they are paying on their outstanding debt obligations. One explanation for this is that companies are still holding on to cash that was borrowed when interest rates were close to the "zero bound." With interest rates having risen dramatically over the past eighteen months, monies that were unspent and invested in variable-rate debt obligations are earning much higher levels of interest than a company's fixed-rate debt expense.

What is important to note, however, is that this positive occurrence is mostly relevant for "large cap" (refers to a company with a market capitalization value of more than $10 billion) companies. Small-cap companies (shares of companies with a total market capitalization in the range of about $300 million to $2 billion) are typically more reliant on borrowing monies utilizing floating-rate loans. Therefore, it will be the small-cap companies that are more apt to be punished by rising interest rates. In fact, it is likely that in many instances the borrowing costs of these companies may have doubled.

- Zombies

Companies with heavily over-indebted balance sheets and on the brink of financial failure ("Zombie" companies) were kept on life support following the 2008 Great Financial Crisis through government programs such as Quantitative Easing (QE). Likewise, during the pandemic, many zombie firms were once again buoyed by the availability of cheap credit and generous government financial aid programs. While the decisions by those in Washington did serve to postpone a swath of corporate failures in 2020-2021, surging interest rates are now proving to be an insurmountable headwind for many of these unviable and unproductive borrowers.

Looked at more broadly, Chapter 11 bankruptcy filings were up more than 50% in August, marking the 13th straight month that bankruptcies rose (Source: Epiq Bankruptcy). In the first six months of 2023, the level of insolvency reached levels not recorded since 2010 (Source: S&P). With the Federal Reserve hiking interest rates to levels not seen in 22 years, access to external financing has caused greater amounts of pain for firms in distress compared to relatively healthy firms. Therefore, it should come as no surprise that large-cap corporations have performed better on a relative basis, as most of the bankruptcy filings occurred in small and mid-cap firms (Source: Wall Street Journal).

- Credit Card Delinquency Rates

As one would expect, individuals are also wobbling from a combination of staggering inflation and high interest rates. Commensurate with credit card debt topping the one trillion milestone for the first time in history, one would expect the pace of delinquencies to be spiking as well. From a 50,000-foot perspective, however, this does not appear to be the case as the delinquency rate on credit card loans reported by all commercial banks, while elevated, is still below the average rate scored over the past decades.

Drilling down inside the data, however, reveals a dichotomy of results that are glaring. Specifically, banks ranked in the 100 largest are experiencing a modest delinquency rate of 2.63%, while banks <u>not</u> in the 100 largest categories are encountering late payment rates that have reached a historic mark of 7.51% (Source: FRED). This data squares with a sharp decline in the personal savings rate as that measurement is approaching historic lows providing further evidence that the financial means of many citizens is already pressured.

For some who are already experiencing financial stress, things are about to get a whole lot worse. Unfortunately, for approximately 27 million people, budgets may need to be cut further as payments on student loan obligations are set to resume after a nearly four-year hiatus (Source: NY Times). With consumer spending representing approximately 70% of GDP, the impact on our nation's businesses could be significant, as less disposable income is available to be spent.

Globally, Who Can't Stands No More?

Unfortunately, the economic set-up highlighted above is consistent with the weakening underpinnings witnessed around the globe. In fact, the pace of business bankruptcies in many countries is spiking to levels not recorded since the Great Financial Crisis (GFC). A decade of cheap money created the fairy tale of invincibility and now with interest rates surging globally, the ability to service the debt is waning. Some examples of financial stress include:

- The number of bankruptcies in Germany has been rising at the fastest rate since the GFC in 2008 (Source: Trading Economics).
- In the first six months of 2023, Japanese bankruptcies hit a 5 year high (Source: WSJ).
- Bankruptcies in Sweden are the highest since 1999 (Source: WSJ).
- In England and Wales, company insolvencies are near the highs reached during the GFC (Source: Trading Economics).
- In France, the number of bankruptcies is at its highest since 2016 (Source: Trading Economics).
- China: One can only imagine! The data is unreliable. (Source: RSW Investments)

From Popeye to Minsky

While the masses consume the Federal Reserve's rhetoric and their policy mistakes, the markets determine where market rates should be, not the Fed. For example, despite the Federal Reserve leaving rates unchanged since July 26, the Ten-Year U.S. Treasury bond yield has spiked from 3.87% to today's rate of 4.64%. These higher yields combined with an intolerable level of inflation, bloated debt levels, and poor income growth should cause the consumer to buckle and thus economic activity to contract sharply.

For individuals and institutions globally, The Popeye moment has arrived, as too many appear to be at the breaking point where they "can't stands no more." Can the Minsky Moment be too far behind?

As was stated in RSW's second quarter commentary while projecting the future pace of economic activity: "Over the coming months, it is likely that this episode of relative strength should become exhausted." Given the dramatic rise in interest rates this quarter, it is fair to say that the markets are forecasting a continued period of rising inflation and robust growth. You guessed correctly! RSW is projecting the opposite trend. Simply put, there are just too many forces ganging up on the consumer. With the belief that the short-term period of economic umph is likely to be behind us, a dramatic decline in interest rates shouldn't be far behind.

This year, RSW has maintained a protective portfolio positioning in the spirit of minimizing a loss of principal during an unprecedented rate surge. However, the time for our team to <u>begin</u> a process of reversing defensive portfolio positioning to capitalize on the weakness in bond prices is now. This shift should be gradual unless market conditions dictate that we too grab some 'spinach' and speed up our investment process.

Municipal Bond Commentary

Tax-exempt bond prices were pressured during the third quarter on the back of a relentless rise in U.S. Treasury bond yields. For example, Ten-Year "AAA"-rated municipal bond yields rose by 89 basis points compared to comparable maturity U.S. Treasury obligations which rose by 73 basis points. Initially, tax-exempt bond yields were stubborn to move to the upside as the level of demand exceeded the pace of new-issue municipal bond supply. This occurred as investors were busily reinvesting proceeds from an outsized amount of cash flow arising from bond calls, maturing securities, and coupon payments. This elevated demand which often occurs during the December to February and June to August time periods is typically accompanied by periods of relatively light new issue supply.

Historically, RSW has seized the opportunity to extend the interest rate sensitivity (duration) of our portfolios to generate enhanced price appreciation during these favorable seasonal periods. However, from a tactical standpoint, we were concerned that market yields would print new cycle highs. To that end, as was outlined in RSW's second quarter commentary titled, "The Marathon of Waiting", we continued to hold the line on a relatively low level of interest rate sensitivity in our client portfolios.

This outlook proved correct as U.S. Treasury bond yields spiked. In addition, over the last month, with the seasonal nature of the market no longer providing a tailwind, high-quality municipal bond yields began to rise at a quicker pace than comparable maturity U.S. Treasury Obligations.

Moving forward, our tact is to breathe in additional levels of interest rate sensitivity into our client accounts. The goal of which is to lock in today's relatively high yields for longer thus increasing the potential for capital appreciation, should our long-term forecast for dramatically lower market yields prove to be correct.

Robert S. Waas
Chief Executive Officer/Chief Investment Officer

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 Portfolio Manager	Hernando S. Montero Municipal Bond Credit Analyst	Marites V. Pasturan Director of Software and Technology	Jeffrey S. Thompson Investment Reporting Analyst	Anthonio Bacchetta Client Service Associate	Joseph A. Venturini Trade Operations Associate