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RSW's Q1 2025 Fixed Income Newsletter

Shocking Change Blitzes the Status Quo

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Over the many years, we at RSW have been sounding the alarm about worrisome issues such as the unsustainable level of U.S. debt obligations, staggering amount of annual interest expense, ballooning annual budget deficits, demographic shifts, and the upsetting amount of underfunded government entitlement programs. With our nation's debt growing at a faster pace than economic activity, gritty and, yes, shocking methods to reverse course have been necessary. While the media rails against the unconventional approach to solving our crisis, what's missing is an honest conversation about the seriousness of our country's challenges.

Simply put, bold initiatives are required to put our country on a sound financial path. Unfortunately, it is too late to rely on modest tweaks or trimming around the edges to correct our fiscal imbalance. While the jury is out on whether the medicine being applied by the Trump administration to our country's disease is correct, all the ingredients of the "cocktail" must be examined to project the most likely outcomes.

Everything but the Kitchen Sink

Media headlines can unnerve even the most experienced prognosticators and investors particularly when the talking heads and journalists latch on to one policy initiative rather than the collective. Tariffs are a great example, as the narrative surrounding this "tax" is labeled as bad, stupid, and reckless. Wouldn't it be fantastic if the story ended there and no higher level of intelligence was needed to forecast the trajectory of the markets and our nation's economic activity? As always, we must study and dissect all available information, or the tree will get in the way of being able to see the forest.

Aside from tariffs, expanded tax breaks, shrinking the size of the federal government, elimination of countless regulations, and striving to be energy dominant are just some of the additional building blocks being applied to upend the status quo. An entire commentary can be written about each policy, but in the spirit of brevity, suffice it to say that some are inflationary/pro-growth and others are deflationary and restrain growth.

U.S. Treasury Secretary Scott Bessent recently highlighted the potential economic impact of these strategies on CNBC: "There's going to be a natural adjustment as we move away from public spending to private spending. The market and the economy have just become hooked, and we've become addicted to this government spending, and there's going to be a detox period."

For decades, governmental policies and programs have played a conspicuous role in altering the trajectory of U.S. GDP. This was especially true during the Great Financial Crisis and in combatting the economic decline stemming from the pandemic. In fact, over the last year, when our economy was characterized as healthy, various lifelines and stimulus were employed to boost growth, resulting in an eye-popping two trillion-dollar annual deficit.

Shenanigans

As home prices were surging across the country, the Federal Housing Administration (FHA) was busy extending loans to borrowers who were financially impaired. Yup, we've seen this movie before! It was reported by the Wall Street Journal (WSJ) that despite homeowners being delinquent on their mortgage payments, the FHA allowed individuals to stay in their home's payment free, thereby avoiding foreclosure. In fact, of the more than 52,000 FHA loans categorized as seriously delinquent (90 days or more) only 9 resulted in foreclosure.

Tragically, this scheme had the effect of transferring the liability from the homeowner to the taxpayer. Under this arrangement, the originator of the loans wasn't concerned about the creditworthiness or lack thereof of the borrower because they knew that the FHA would reimburse them for any losses. Today the FHA's loan portfolio is toxic as individuals considered to be seriously delinquent on their payments have eclipsed the pace set during the subprime crisis. Further highlighting the debacle is the fact that 79% of FHA borrowers have one month or less of savings. To make matters worse, according to the WSJ, this program has been operating in secrecy without the knowledge of Congress.

C'mon Rob! Where are you going with this? Relax! With the table now set I'm ready to serve the final thoughts.

Closing Time

No one can know with absolute certainty how our future looks when the governmental crutches are kicked out from under the patient's arms. One thing is for certain though, many stumbles and wobbles lie ahead.

The Department of Government Efficiency (DOGE) headed by Elon Musk is facing unprecedented challenges in their attempt to downsize the federal government's expenditures. It is likely though that in the last half of the year many of the legal challenges should be cleared. However, even if they have the green light to proceed with their mission, the consequences could also be ugly. To illustrate, let's use the debacle unfolding at the FHA as an example which should serve to illustrate the Administration's challenges.

If President Trump targets and is successful in abolishing these deceptive and irresponsible practices, foreclosures will surge, housing inventory would therefore escalate causing home prices to fall. Once the houses are sold, the decline in property values would intensify taxpayer losses. Lastly, should housing price declines become acute, an even larger share of the populace's mortgages may exceed their home values, thus enticing individuals to walk away from their obligations.

Over the near term, economic activity should continue to be supported by the fiscal stimulus that persists from the prior administration. Given that extreme budget deficits are a root cause of the stubborn rate of inflation, lack of serious progress in expense reduction may continue to frustrate bond investors. This should keep upward pressure on interest rates for a while longer as bond investors become frustrated with the lack of progress on deficit reduction.

As we stated in the 2025 Outlook, however, the back half of the year should see economic activity declining markedly as the administration works through the roadblocks to implement a dizzying array of budget cuts. As revenue and expenses are brought into greater balance, the size of the treasury auctions will decline, and inflation should cool, thereby allowing market yields to recede.

Municipal Market Commentary

Municipal bonds experienced a challenging quarter, pressured by a surge in new issue volume and lackluster investor flows. Longer-dated tax-exempt bonds experienced the greatest amount of price pressure, as yields in the 10-to-15-year sector (RSW's target maturity range) rose more than four times faster than securities maturing in five years (RSW's benchmark).

Further contributing to market apathy is the uncertainty surrounding state and local government finances. Over the past two years, with private sector hiring slowing, it has been the municipal sector that has been a driving force in the labor market. In fact, the pace of staff additions has happened at a breakneck pace not seen in decades (Pew). With over 20% of the job growth coming from the state and local government sector, as the economy slows, and hiring freezes and/or layoffs ensue, upward pressure will be applied to the nation's unemployment rate. As the tightening of the belt ensues, this will undoubtedly contribute to weaker economic activity.

Aside from our prognostication calling for U.S. Treasury bond yields to rise in the first half of the year, we elected to reign in the duration (measure of interest rate sensitivity) of our client portfolios due to the relative valuation between U.S. Treasury bonds and municipal securities. This can be seen in the relative yield relationship of 10-year "AAA"-rated tax-exempt bonds as a percentage of comparable maturity U.S. Treasury debt (ratio) which declined to 67% at year end. While this ratio is spot on the two-year average, the ten-year relationship stands at 84%. As a refresher, the higher ratio suggests that tax-exempt securities are more attractive alternative investment.

Looking ahead, we will continue to be positioned more defensively until market yields appear to be cresting. Lastly, should market yields of "A"-rated bonds rise at a more precipitous pace compared with RSW's higher quality securities, we will have the opportunity to exchange a portion of our higher quality securities for those bonds to enhance income.

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