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RSW's 2025 Investment Outlook

"The Dots Won't Connect Themselves"

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The Dots Won't Connect Themselves

With the election uncertainty and anxiety behind us, many questions remain unanswered. If President-elect Trump's federal policies are enacted, what effect could they have on economics, inflation, and interest rates? Let's explore the impact of these policies from 50,000 feet rather than get hung up with the nuances of a plan that is still in motion. There is a lot to unpack here, some a bit technical, so let's roll up our sleeves and get to work.

During the election cycle, a spotlight was directed at the size of the federal budget deficit. With federal spending up 40% since 2019 (Source: Cato institute), the annual budget deficit surpassing $2 trillion, a cumulative federal deficit topping $36 trillion, and annual interest payments on the bloated debt reaching $1 trillion, is there any wonder why Americans are concerned about the direction of our country?

Time to Connect the Dots!

Remember when Modern Monetary Theory (MMT) was all the rage? As we discussed in RSW's Q1 2019 commentary, a gaggle of Washington elected officials bought into the MMT nonsense, believing that countries that issue bonds in their own currencies do not need to worry about how much the government spends. "These advocates believed that a flood of money and increased spending isn't likely to generate a surge in the rate of inflation, because it hasn't happened yet."

As you may recall, in March of 2020, unconcerned about the impact on inflation, the Fed once again embarked on a strategy of Quantitative Easing (QE). To ensure that there was enough liquidity in the system that could flow through to the economy, the Fed utilized their balance sheet to spend billions of dollars to purchase U.S. Treasury and mortgage bonds. During the January 2020 through June 2022 period, the Federal Reserve's balance sheet virtually doubled, expanding from $4.2 trillion to $8.9 trillion.

As always, the ultimate culprit for inflation is too much money chasing too few goods. With the Federal Reserve expanding the money supply (measured by *M2) by an unprecedented amount, combined with out-of-control deficit spending by lawmakers, a near-perfect environment was created for inflation to flourish. All that was missing was a surge in consumer demand, and that certainly emerged once the economy reopened post-COVID.

Despite these occurrences, there is a large group of folks who believe that supply chain disruptions were to blame for the steep rate of inflation. These disturbances were painful, but the theory is incorrect! Suppose you were running a manufacturing business and your input material costs surged and were difficult to obtain. Against this backdrop, of course, some of that added cost would be passed along to consumers.

But the inflation story does not end here. If consumers paid elevated costs for some items, they would have less money left over to purchase other goods, causing the prices of those items to fall to attract buyers. Therefore, when all factors are considered, there should be little resultant change to the average rate of inflation.

Nowadays, it seems like every commentator, journalist, Fed Governor, et al. are all experts on inflation. There have been so many theories on the broad-based price increases that it is easy to lose track of them all. Remember when it was all the rage to singularly blame surging prices during 2021-2022 on the invasion of Ukraine by Putin?

Now, these same folks are lecturing and warning us that tariffs and deportations will spike the pace of inflation. While the merits of these plans can be debated, that's not our role to play. Instead, our focus remains on analyzing their potential impact on the rate of inflation while ignoring the political spin and hyperbole.

Tariffs

With all the talk and bluster surrounding tariffs, it's important to define them and project their impact on consumers and impacted countries. In short, a tariff is a tax on imports that is paid by domestic companies. For example, let's assume that an American company, ABC Corp, wanted to import solar panels from China.

When the product arrives at the port, ABC Corp will be informed that it owes a 60% tax on the total cost of the panels. Thus, China does not pay the tax; ABC Corp does. Many economists assume that the cost of imports would rise by the amount of the tariffs as ABC Corp passes along the entire tax to consumers.

In many instances this assumption is too aggressive because ABC Corp can decide to raise its prices to offset only a part of the tax or "eat" the entire tax and pass none of the increase to consumers. Furthermore, their simplistic methodology doesn't account for the changing behavior of companies and consumers. As prices rise for imported goods, demand falls as buyers search for lower-cost alternatives.

In fact, imports from China now account for a substantially smaller percentage of total imports than during Trump's first term. As tariffs were levied, American companies shifted production from China and increased manufacturing capabilities to other countries such as Mexico, Taiwan, and Vietnam. Of course, these shifts were instrumental in suppressing the rate of inflation.

Another consequence of tariffs is the fluctuations they trigger in a country's exchange rate. Think about it! As demand is diminished for foreign goods, there is less demand for that country's currency, causing its value to fall compared to the dollar.

During Trump's first term, the Yuan weakened by more than 12% (Source: Bloomberg) versus the dollar, helping to erase some or all the burden that the tariffs cost American buyers. On the flipside, a weaker exchange rate directly impacts the revenues of Chinese producers. Even if their sales volume rose modestly, by collecting less dollars for their sales of goods, their profitability still suffered.

Immigration

The current talking points argue that low or negative immigration will cause inflation to surge. Let's think about this logically. Proponents of high immigration have claimed that the new entrants into our country propel our nation's economic growth. As those folks gain employment, they become a source of demand for goods and services. Yep, makes sense to me! But if that's true, shouldn't deportations reduce not only the supply of labor but their spending as well? Wouldn't that activity be deflationary?

Tax Rates

Many tax cuts initiated in the Tax Cuts and Jobs ACT (TCJA) are set to expire in 2025. While Trump has yet to release a detailed plan, it is likely that the cuts will be extended or made permanent. As far as the President-elect's desire to reduce corporate tax rates further, we believe these cuts will be more difficult for Congress to swallow. Bottom line: with respect to tax rates, it is probable that there are no meaningful changes to the policies on the books today.

Budget Cuts

The newly created Department of Government Efficiency (DOGE), led by Elon Musk and Vivek Ramaswamy, has a clear mandate to slash government expenditures. However, if the team has a shot of putting our nation on a glidepath to a balanced budget, they will have to use a sledgehammer, not a scalpel.

Recently, the House passed a bill that provides government workers with an increase to the social security benefits amounting to $196 billion. This should highlight the difficulty of the task at hand for DOGE. While the Republican party has a slim majority in the House and Senate, it may not be enough to clear the hurdle, as there is a bipartisan impulse to grow the size of government.

Furthermore, given the $1-2 trillion dollars in spending that DOGE is seeking to cut, it is likely that entitlement programs will have to be reformed. For decades, there has not been a willingness for politicians to tackle this "third rail" issue. Will this team have the spine or inclination to push for a restructure of these runaway costs? Time will tell, but it is not likely.

Notwithstanding their ability to curb entitlement expenses, should DOGE meaningfully cut the deficit, a marked improvement could lead to lower levels of inflation. In turn, this should reduce the size of future U.S. Treasury borrowing and therefore the level of new U.S. Treasury bond issuance, allowing for supply-to-demand to be brought into equilibrium.

Drilling and Regulations

At this juncture, while we have sparse information on Trump's proposed expansive energy policy and desire to slash government-imposed regulations on businesses, when combined, these shifts should have a minimal impact on the pace of inflation. On one hand, the removal of government impediments should facilitate stronger economic activity and could serve as a catalyst to push inflation higher. However, should enhanced exploration and drilling produce meaningfully lower energy prices over the next 12 months, this activity could prove to be a powerful deflationary force.

Conclusion: Perception Versus Reality

In RSW's 2024 Outlook, the forecast called for 10-year U.S. Treasury bond yields to reach 3.25%. This prognostication proved to be too aggressive, as rates bottomed out at 3.62%. Since the fourth quarter, interest rates have been rapidly moving higher as market participants remain concerned that the plans of the new administration will strengthen economic activity, causing inflation to reignite.

Tariffs are perceived to be the main concern among market participants, but as we outlined within these pages, this conclusion is likely rooted in fear. There are several offsetting outcomes for the increased use of a stiff tariff strategy, and this policy in and of itself should only have a minimal impact on the rate of inflation.

Furthermore, as we move through the year, it should become obvious that some of President-elect Trump's rhetoric is simply bluster used as a negotiating tactic. After all, the intrigue and hand-wringing are over, we need to be mindful that similar policies were in force during the last Trump administration. As you may recall, for the three years leading up to COVID, the inflation rate averaged only 1.90%.

The decisions by the Federal Reserve have also proven to be a source of anxiety. Chairman Powell has been busily cutting rates despite his carefully watched inflation benchmark still above the 2% target rate. This is an unusual activity and one of the reasons why market yields are rising today and are dramatically higher than when the Fed started their rate-cutting cycle back on September 18th.

Given the perception that inflation is about to soar, it is likely that 10-year U.S. Treasury yields will make a new cycle high. A 5% yield acts like a magnet, and it is probable that yields top that level before the uncertainty dissipates. By the second quarter of 2025 it is likely that the pendulum swings back the other way and rates begin their decline.

As we have witnessed and commented on numerous occasions before, it is the higher rates that act as a self-breaking mechanism for economic activity. With an economy that is so highly leveraged, rising interest rates should provide another impetus for the housing market to cool and a broad-based consumer-led spending retrenchment. In the second half of the year, this should allow 10-year yields to decline toward the recent low of 3.62%. In the end, reality should trump perception. Just need to connect the dots!

Municipal Commentary

During the fourth quarter, the municipal bond market was held hostage by rising U.S. Treasury bond yields. With that said, prices of municipal bonds held up relatively well. As a guidepost, thus far for the period 10-year U.S. Treasury bond yields rose by 81 basis points, while comparable maturity “AAA”-rated tax-exempt yields rose by a more modest 48 basis points.

For the year, the total rate of returns in the tax-free market was disparate and dependent on the bonds stated final maturity date. For example, bonds maturing in 5, 10, and 15-years produced returns of +1.01%, (-0.58%), and +0.40% respectively. Given that the foundation of RSW’s intermediate duration strategies rely on investing a dominant share of assets in bonds maturing between 10 and 15-years, the results were pressured versus their Bloomberg 5-year index.

As the firm enters its 20-year anniversary, it’s important to note that this dichotomy of results is not new. Over shorter time periods, the returns of RSW’s strategies may wander and often under-perform or out-perform versus their shorter maturity index. However, over longer periods of time, the results are more similar. We expect this time will be no different and believe the investment philosophy should continue to produce superior returns going forward.

Given our forecast for rates to rise through the first quarter, as opportunities permit and where appropriate, we have been actively reducing the interest rate sensitivity of our client portfolios. Our goal of risk reduction over the near term will be to provide us with the “room” to extend duration (measure of interest rate sensitivity) once yields are in the process of cresting. The rate rise should therefore provide us with a chance to not only enhance yield/income but also with an opportunity to maximize price appreciation.

The Republican trifecta means change is in the air; you can count on it! Nevertheless, despite the swirling currents, we believe that no ill winds are in the forecast for the municipal bond market. Although the Department of Government Efficiency is looking under every rock to cut expenses, we believe no changes will occur with respect to tax-exemption. Occasionally, since the inception of the income tax in 1913 tax-exemption has been challenged with rare and minimal success. In fact, the opposite is true; over the past 45 years, the size of newly issued municipal bonds has exploded from approximately $40 billion annually to almost $500 billion.

The base for municipal bonds has expanded to include non-governmental organizations (NGOs) including cultural facilities, charter schools, foundations, 501-3 entities including health care and higher education, airports and port facilities, and private- public enterprises. The bottom line is simply that the municipal market is the capital resource for most of the nation's infrastructure. This is recognized by both political parties. Any potential cut around the edges of the municipal market would not amount to "spitting in the wind" in addressing any real federal budget deficit reduction.

Last but certainly not least…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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