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# RSW's Q2 2024 Fixed Income Newsletter

## All Gas, No Brake

## "All Gas, No Brake"

The 2023 Football season held so much promise for the New York Jets. Led by the veteran quarterback Aaron Rodgers, in his debut appearance as a Jet, the 39-year-old was favored by many to lead the team to the Super Bowl. Hence the tag line "All Gas, No Brake" was conceived to capture their excitement and promise. The unbridled enthusiasm crashed however on the fourth play of the first regular season game, with Rodgers getting sacked and sustaining an injury to his Achilles tendon. With their team leader being sidelined for the rest of the season, the win loss record fell to a dismal 7-10.

Since the Great Financial Crisis of 2008 (GFC), the U.S. federal government has acted with an "all gas, no brake" mentality, spending money at a break-neck pace. With government expenditures outpacing receipts, the U.S. has had to borrow to cover the deficit. Despite tax revenue having increased by over 100% from $2.5 trillion to nearly $5 trillion over the last 16 years, this amount was dwarfed by the 116% increase in the annualized pace of government spending, which today stands at $6.8 trillion.

**Penalty Flag**

A continuation of this unrelenting behavior has caused the cumulative level of outstanding U.S. Treasury obligations to skyrocket. In fact, since the GFC, the national debt has increased by nearly $23 trillion (from $12 trillion to almost $35 trillion). Until recently, the injurious policies of borrowing and spending to create economic growth were less apparent. Prior to the recent 40-year high in the pace of inflation, it was believed by many that "deficit spending" was a riskless endeavor. The Congressional Budget Office (CBO) is now "throwing the flag" as the size of this year's budget gap is expected to top $2 trillion.

The surge in borrowing and related escalation in the size of U.S. Treasury bond auctions have caused interest rates to rise dramatically. Simply put, lenders have demanded higher yields to compensate for the elevated amount of new debt issuance and such risks as inflation and the possibility of a default. Interest expense has quickly become one of the largest budget items, as the cost of funding the government's total outstanding debt since 2008 has increased from 8% of annual federal spending to 13%.

For decades, many economists argued that increasing public debt and related spending would produce a positive multiplier effect. For example, if the government borrows and spends one dollar, then three dollars of enhanced GDP growth could be the result. However, after reading over a dozen comprehensive research reports on this topic, our long-held belief that there is a breaking point at which each new dollar of debt diminishes the U.S. GDP (Gross Domestic Product) growth rate has become confirmed and reinforced.

One of the most prominent and well-regarded papers on this topic, "Growth in a Time of Debt" authored by Reinhart and Rogoff, outlines the danger of unrelenting debt expansion. Their analysis, which observes the economic outcomes of forty-four countries and utilizes over 200 years of data, uncovered the harsh reality of unabated debt expansion. Simply put, their findings reveal that when a country's debt as a percentage of GDP exceeds *90%*, GDP could fall by as much as 1%.

As of this writing, the outstanding U.S. national debt is approximately $35 trillion. Given a projection of $29 trillion for U.S. Gross Domestic Product, our nation's debt ratio stands at *121%.* While this is an alarming statistic, the trajectory of the budget deficit is likely to remain intact. Now that we are in a debt crisis, the measures taken to get the deficit under control may only serve to exacerbate the issues. For example, an attempt to enhance revenue through higher taxes and/or meaningful cuts to the annual budget should only lead to slower levels of growth and therefore could serve to put upward pressure on the budget deficit.

**All Brake, No Gas**

In contrast to the Washington elected officials, the bond market followed by the Federal Reserve, has persevered with an "All Brake, No Gas" approach. Interest rates, particularly in shorter-maturity debt, remain highly elevated against a backdrop of slipping economic activity. As we have pointed out in past musings, aside from non-traditional tools such as Quantitative Easing/Tightening, the bond market controls interest rates, not the Federal Reserve.

Furthermore, since 1990, the Fed reacts to the movements in the three-month U.S. Treasury Bill market, not vice versa (Bloomberg data). So, while market participants and pundits attempt to guess when the Fed cuts rates, the answer will reveal itself when the yield of three-month bill securities declines beneath the Federal Reserve's lower target rate of 5.25%. Until then, the Fed will likely take a knee and their policy will remain unchanged.

With the consumer representing close to 70% of the nation's economic activity, we often talk about their financial well-being and attitude. While we have built a case for consumer fatigue over the past many months (prior commentaries can be found on our website, www.rswinvestments.com), the incoming data crystalizes our thesis and moreover deeply concerns us. For example, recent surveys released by the University of Michigan (U of M) are consistent with a consumer that has been tackled and now sidelined.

Specifically, an index based on a survey asking consumers about the "buying conditions for large durable goods" declined to near record lows. This dovetails with another U of M index created around household income expectations. This survey is also going in the wrong direction and serves to underscore consumer pessimism, as the index sits at similar levels recorded during the GFC.

In prior commentaries we have commented on the debacle unfolding in the Commercial Real Estate market. With that said, we now feel compelled to address rapid changes occurring in the single-family housing market. According to recent results of a U of M Index which asked participants if it is a good or bad time to purchase a home, this survey now sits at the lowest level recorded in over 45 years. This is undoubtably the result of many detrimental forces. These include elevated mortgage rates, the effects of incomes that for many months fell short of the rate of inflation, and home prices that have surged since the pandemic.

**Conclusion**

While the masses cheered the end to the financial crisis, we have been reluctant to do so. No, not because we are unpatriotic or enjoy maintaining a negative bias. Just like an impartial accountant, we must pay equal attention to the asset side of a balance sheet (our nation's growth rate) and the liability portion of the financial statement (outstanding financial obligations). Namely, how much of that growth was attained by expanding the level of U.S. indebtedness?

With the individual's propensity to spend running on empty, the Achilles heel for a rebound in economic activity is a weakened consumer. Driven by market participants and with the Fed's foot still firmly on the brake, the much talked about "soft landing" scenario (firm economic activity coupled with low inflation), in RSW's opinion, is nothing more than unbridled enthusiasm and/or "irrational exuberance". In fact, the odds that quarterback Aaron Rodgers makes a complete recovery in 2024 and leads the Jets to a Super Bowl victory is much more likely.

So, what does all this mean for the future direction of interest rates? As we have witnessed during prior periods of economic and/or financial stress, when the pundits talk about "higher interest rates for longer", we know what usually follows. Namely, lower rates for longer. Stay tuned!

**Municipal Commentary**

During the quarter, 10-year U.S. Treasury bond yields climbed by 20 basis points, compared to comparable maturity "AAA"-rated tax-exempt bond yields whose yields rose by 33 basis points. The underperformance of the municipal bond market can mostly be attributed to an elevated level of new issue supply, as the 2024 year-to-date volume exceeded last year's pace by 39%.

We now find ourselves amid the second of two favorable seasonal periods supportive of firm to rising municipal bond prices. With bonds paying coupon income semi-annually and with an outsized amount of securities carrying maturity dates of December and January 1, investors not only receive higher levels of cash flow in the winter but also the summer months. With these proceeds busily being reinvested back into the tax-exempt market, demand should once again exceed supply.

Believing rates still had more upside potential, as you may recall from RSW's Q1 commentary, we paused our plan to enhance the interest rate sensitivity (as measured by duration) of our client portfolios. With rates continuing their ascent during the second quarter, and what we believed to be the final upward thrust, we reengaged our strategy during the period. Specifically, we pushed the interest rate sensitivity of our intermediate duration clients approximately 24% above their stated benchmark, to levels not reached in nearly a dozen years.

It is important to note that while we are proceeding with a high degree of confidence in our analysis, we are not turning a "blind eye" to the elevated level of crosscurrents. From politics to world events, the changes are

unfolding fast. As we stay on top of these volatile occurrences, should it become necessary to augment our policy, such changes will be described within the pages of a timely intra-quarterly commentary.

Robert S. Waas
Chief Executive Officer/Chief Investment Officer

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