The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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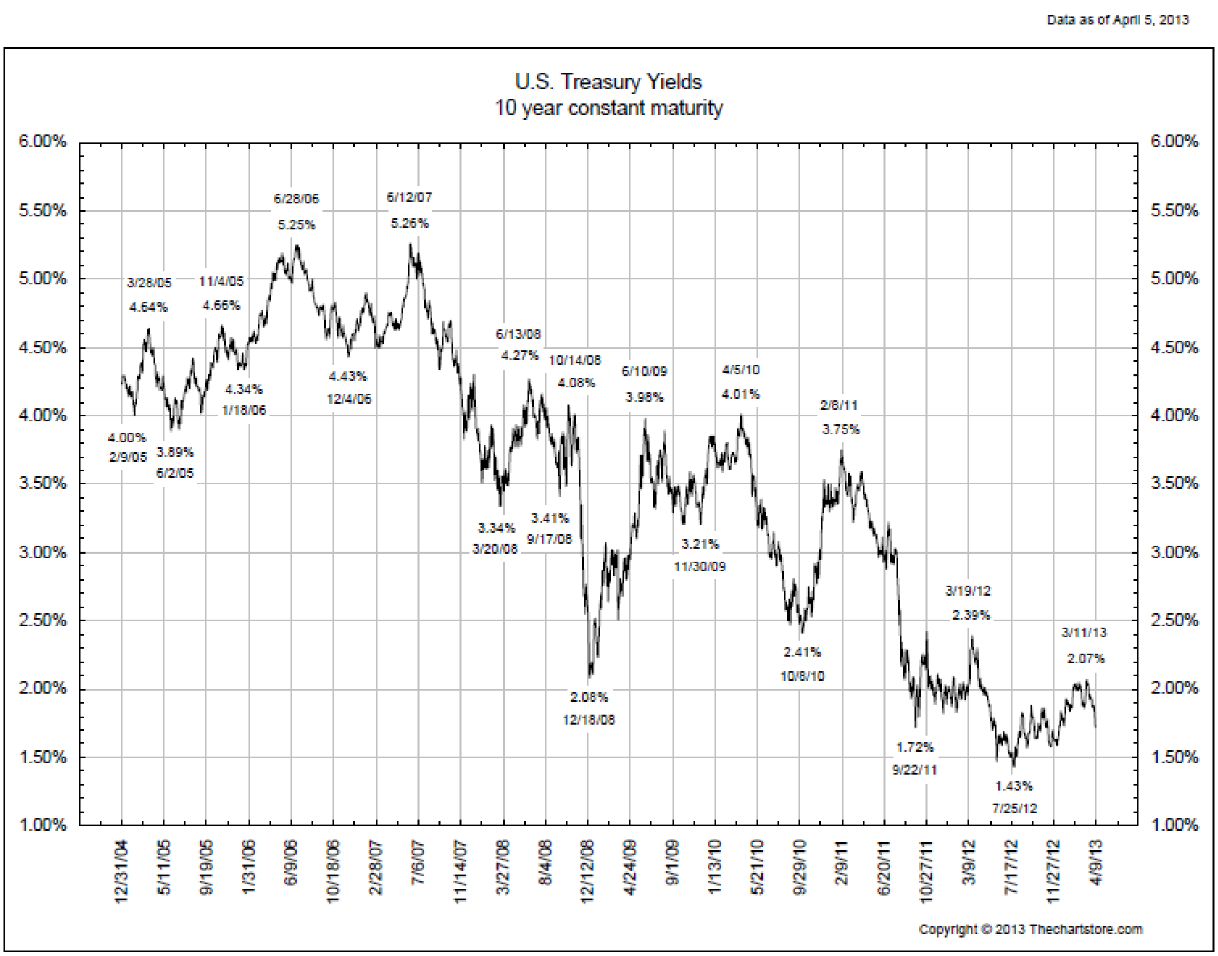
- **Background and Outlook**

Interest rates remain subdued in response to aggressive Federal Reserve accommodation with short rates held near zero and longer yields constrained by the Fed's quantitative easing purchases that are currently absorbing $85 billion U.S. Treasury and agencies securities per month. If this purchase rate continues, the Fed's balance sheet will expand to approximately $4 trillion by year end. As shown in the chart below, the ten year Treasury yield had been trading near 2% after rising late last year, but recently fell to the 1.70% area in response to the Euro zone Cypriot banking crisis where deposit confiscation was threatened and, most significantly, the weaker than expected March U.S. employment report.



Municipal rates have generally followed the lead of the Treasury market but, as is typical, with a lag. The table below traces prime tax-exempt yields over the past year with the end of November low noted. Tax-exempt rates subsequently trended higher in December and during the first quarter of this year but dropped in concert with the Treasury market during the opening days of April. The municipal market is cheap on a relative basis with prime tax-exempt yields near, or slightly above, Treasury rates along the entire yield curve due, to a large extent, to the threat (discussed later) that the tax exempt status of municipals could be impaired.

Prime Municipal Yields

	03-31-12	11-30-12	03-31-13	04-08-13
1 Yr	0.21%	0.20%	0.21%	0.20%
5 Yrs	1.00	0.56	0.86	0.75
10 Yrs	2.10	1.36	1.93	1.71
15 Yrs	2.71	1.82	2.48	2.30
20 Yrs	3.06	2.12	2.73	2.55
30 Yrs	3.38	2.45	3.09	2.92

Low Treasury yields combined with negative rates on Treasury Income Protected Securities (TIPS) indicate that the market's expectation is that inflation will be in the 2.5 - 3.0% area for the foreseeable future. Real returns on Treasuries and high quality tax-exempt securities are negative (before considering income taxes) and have been for some time. How long is this situation likely to continue? Given the Fed's ability to control rates, probably as long as the monetary authorities are inclined to maintain accommodation. Chairman Bernanke recently restated the Fed's plan to stay the course until economic growth accelerates and the unemployment rate declines to 6.5% or lower. We therefore anticipate that the low rate environment will prevail for several more months and probably into next year. Investors should, however, be on alert for any sign that the Fed might alter its stance. A significant jump in rates seems likely when the Fed ultimately slows the rate of QE bond purchases. Investor caution is therefore called for. We continue to target portfolio durations at 3.6 years, approximately 15% below neutral and remain poised to further reduce durations if conditions warrant.

- **Not the Time to Chase Yield**

The search for higher returns in the low rate environment has prompted some investors to move further along the yield curve and lower quality standards. Both moves are dangerous. A shift in market sentiment could easily cause the yield curve to move abruptly higher and precipitate sharp price declines in longer maturity bonds. A ten year bond currently trading near par could experience a price drop of ten points or more if rates moved higher by 100 basis points in reaction to both the rate rise and the de minimis impact - buyers of deep discount bonds being subject to ordinary income tax payments on the portion of a discount security's return related to the price accretion back to par.

In addition to the volatility risk associated with rising rates, quality spreads are low after narrowing dramatically as rates declined. Spreads will likely re-widen in a rising rate environment. A few years ago the spread between AAA and BBB tax-exempt securities ranged from 250 to 350 basis points. The spread is currently about 125 basis points. Less than investment grade debt that traded at yields exceeding 10% a few years ago is now being offered at under 5% in ten year and shorter maturities. A sharp rise in rates coupled with spread widening would have a devastating impact on the principal valuations of long, low quality bonds. High yield bond funds could be especially susceptible to significant price declines.

We strongly urge that high quality standards be maintained and portfolio durations be controlled. We continue to invest only in high quality, liquid securities and utilize barbell portfolio constructions with limited durations that limit volatility risk. Our primary goal of avoiding negative total returns in any calendar year remains unaltered.

- **Stockton, California Bankruptcy**

As reported in previous newsletters, Stockton's finances were severely impacted during the recession as property values plunged, unemployment soared and tax receipts plummeted. Despite layoffs and extensive expense reductions, the City incurred a $26 million general fund deficit in 2012 and was unable to support the $700 million in bond debt it had outstanding. To date the City has missed payments on four outstanding bond series, all of which are insured.

The City opted to file for bankruptcy in June of last year and the federal judge presiding over the case recently ruled that the City is eligible to file under Chapter 9 of the federal bankruptcy code. Criteria that must be met for a municipality to successfully file for Chapter 9 protection are: 1) insolvency; 2) ability to file under applicable state law; and 3) evidence that the municipality has negotiated in good faith with creditors holding a majority of the claims that the municipality intends to impair under its plan of adjustment. The Bankruptcy Court found that Stockton was indeed insolvent, that California law allowed it to file for Chapter 9 protection and that the City had bargained in good faith. The latter point was contested by a Capital Markets Creditors Group (Assured Guaranty, Franklin Advisers and Wells Fargo) who argued that the City's refusal to seek concessions from California Public Employees Retirement System (CalPERS), its largest unsecured creditor, nor consider any pension reductions, unduly burdened bondholders – especially since the City issued some of its outstanding bonds to cover unfunded CalPERS obligations that total an estimated $900 million. The court dismissed this argument and opined that there was no requirement that the City enter into negotiations with CalPERS at this time.

The court's determination of Stockton's eligibility to enter bankruptcy is just the first step in the reorganization process. A final plan of adjustment will not be developed and approved until well into the future and is certain to involve numerous adjustments and refinements as creditor negotiations continue. The major unresolved question is whether Stockton will negotiate with CalPERS to reduce the City's pension debt. This decision will have a significant impact on bondholder recovery.

It is important for investors to keep several points in mind. Municipal bankruptcy filings have been and are likely to continue to be rare. Vallejo, CA reorganized under Chapter 9 a few years ago and San Bernardino has filed, but the eligibility of San Bernardino's petition has not been determined by the bankruptcy court. Petitions by Boise County, Idaho and Harrisburg, PA, two other recent prominent examples, were rejected by the courts. Stockton does not have general obligation debt outstanding so the issue of a "full faith and credit pledge" will not be addressed in this case. Still, decisions by Vallejo, Stockton and San Bernardino to seek bankruptcy protection evidence the fact that fiscal stress has not gone away. The need for credit scrutiny remains paramount in security selection.

- **Tax Exemption Threat**

It has been reported that the President's budget proposal expected later this month will include a 28% itemized deduction limit for individuals earning more than $200,000 or families with annual incomes in excess of $250,000. This action would affect home builders, pension plan advisers and charities in addition to impacting municipalities' cost of capital. Each affected group is certain to strongly oppose this action. It has also been reported that fourteen Democratic Senators have urged the President not to propose capping or eliminating the tax exemption for municipal bonds because of the negative impact this action would have on state and local governments' ability to finance critical infrastructure projects.

Other proposals that have been floated seem even more unlikely. The reauthorization of Build America Bonds (BABs) has again been raised, but with a 28% interest rebate by the federal government rather than the 35% rebate that was part of the program in 2010. The 35% rebate on outstanding BABs was recently reduced as part of the current sequester. This action has convinced many local issuers that promised payments by the Federal government to state and local entities can, and quite likely will, be adjusted as Washington's politics and policies are shifted by future Congresses and administrations. A reinstated BAB program seems unlikely.

What is included in tax legislation that ultimately emerges from Congress remains to be seen, but any action that increases municipalities' cost of capital will be strongly resisted by the state and local government officials who view such action as an effort by Washington to shift the federal government's budgetary problems onto governors' and mayors' shoulders. We think that the odds of an infringement of the tax-exemption are relatively small, but cannot be dismissed. We will continue to monitor developments.

- **Puerto Rico Downgrade**

Puerto Rico has recently been in the news. All three rating agencies have lowered Puerto Rico's general obligation debt to just slightly above speculative levels (e.g. BBB-) and some of the Commonwealth's non-GO debt now carries less than investment grade ratings. Puerto Rico is challenged by a struggling economy, poor tax collections, serious budget deficits and a heavy debt burden. Median family income on the island is slightly over $7,000 compared with a $20,500 U.S. median. Debt to GDP has risen to above 100% compared to 58% in 2000. The main government retirement fund is only 6% actuarially funded.

On the positive side of the ledger, the Commonwealth has attempted to improve sales tax collections and the new Governor has completed a planned privatization of the San Juan airport, increased water rates, raised taxes on non-Puerto Rican companies with facilities on the island and enacted pension reform legislation. Since the Puerto Rican citizens are not subject to federal income taxation, the Commonwealth can, arguably, support heavier than normal debt.

Attractive features of Puerto Rican bonds are that they trade cheap and, given Puerto Rico's territorial status, the income they provide is exempt from all federal, state and local income taxes. These securities tend to be used extensively in bond funds, especially single state funds. We have never used Puerto Rico bonds due to the Commonwealth's poor financials and the serious risk of spread widening. Puerto Rico bonds currently trade at a yield premium to the BBB scale. Spreads on these bonds will likely widen further in a rising rate environment. More Puerto Rico headlines, along with other distressed credits (e.g. Detroit) will likely prompt investor anxiety.

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