The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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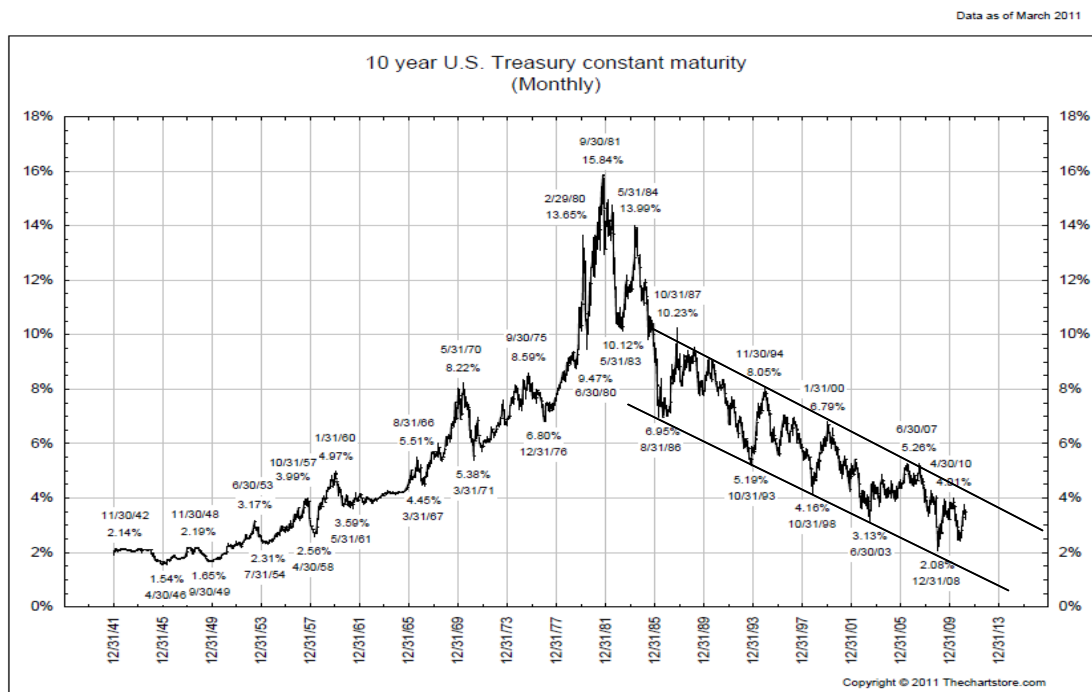
- **Background and Outlook**

Reasonably solid employment reports over the past several months coupled with stronger exports and a pickup in retail sales suggest that the economy is gaining strength and moving from recovery to expansion. However, strong headwinds are likely to temper progress. The depressed housing market, high unemployment, limited wage gains, rising energy prices and the global drag from Japan's earthquake will continue to cloud the outlook. Despite these potential negatives, we expect that the cyclical upswing will remain in place with real GDP growing at a moderate 3+% pace this year and next.

Given this setting, how long will the Federal Reserve maintain its accommodative posture? Several Fed regional bank presidents have suggested that it is time to reduce monetary stimulus to counter potential inflationary pressures. Chairman Bernanke's view is that inflation concerns are currently unwarranted and that the recent surge in food and energy prices will be transitory. He continues to focus on core inflation rates which remain subdued. We expect that the Fed Chairman's view will prevail and that the $600 billion QE II government securities purchases program will be completed this summer as scheduled and that short rates will remain near zero for several more months until there is convincing evidence that the recovery will not falter. The near term outlook for short rates seems reasonably assured.

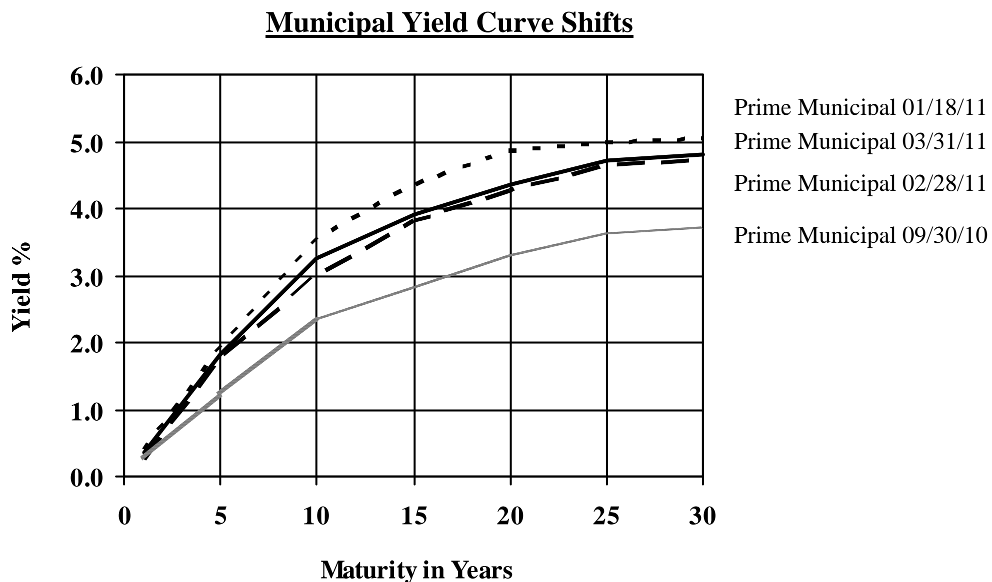


Except for a few brief instances, the ten year Treasury yield has ranged between 2.5% and 4.0% since late 2007 and, as shown in the above chart, remains in the downward sloping channel that has existed since the mid 1980s. This rate trend is likely to persist for many more months until the U.S. economy establishes a more solid footing. We anticipate continued volatility as developments in the Middle East, federal budget negotiations and vacillating economic indicators alter investor enthusiasm for fixed income securities. Ultimately we expect long rates to move higher in response to the Treasury's continued demand for credit while the economy strengthens and inflation pressures intensify. This may be an extended process, but the setting calls for a degree of caution.

The municipal market largely operated in a vacuum during the past quarter with very limited new issue volume to provide pricing guidance. Issuance totaled only $46.9 billion, a 55% decline from the $104.4 billion bonds sold in the first quarter of 2010. The $134 billion surge in supply in the fourth quarter as issuers raced to sell bonds before the Build America Bond window closed satisfied a good amount of existing financing needs. In addition, new governors faced with operating budget challenges have been hesitant to initiate capital spending projects.

With limited trading, tax-exempt yields remained in a relatively narrow band during the quarter. The accompanying yield curve chart reflects the recent trading range which contrasts with the sharply lower tax-exempt rate levels that existed last fall. The long end of the curve has been significantly impacted by the year-end elimination of Build America Bonds which has curtailed demand from non-traditional municipal buyers (e.g. pension funds, foreign entities, etc.). Mutual fund redemptions, requiring sales of long bonds, have further pressured the long end of the yield curve. Casualty insurance companies have also been net sellers leaving individual investors as the primary buyers of tax-exempt securities. Their preference is for shorter maturity bonds, typically under ten years.

Municipal Yield Curve Shifts



We expect that the pace of municipal new issue sales will build slowly over the coming months, but volume for the year is likely to be dramatically below the $433 billion bonds sold last year. There is some fear that additional bonds will cause the municipal prices to swoon, but we feel that increased volume will have a stabilizing effect by providing pricing guidance.

At the end of the quarter ten year prime tax-exempts yielded about 93% of like maturity Treasuries. Barring a shock (a severe municipal credit concern or a flight to quality that would cause government yields to drop as they did in late 2008 when ten year Treasury rates fell to near 2%) we don't anticipate that this ratio will rise dramatically. Still, given our concern that all interest rates are more likely to rise than fall over the intermediate term, we feel that a degree of caution is called for. Portfolio durations remain targeted at 3.7 years compared to neutral positioning at approximately 4.2 years.

- **Reduced Liquidity Persists**

As we have mentioned in the past, the financial disruption in 2008 reduced the number of brokerage firms dealing in municipal securities (e.g. Bear Stearns, Merrill Lynch, Lehman Bros.) and prompted remaining firms to reduce risk exposures. Trading desks now have less capital committed to their operations and traders are far less inclined to take on positions unless they feel confident that bonds can be quickly resold. As a result, we are receiving fewer bids from the brokerage community when we offer bonds for sale. We have expanded the number of trading platforms that we use which has increased our efficiency when liquidating bonds that do not possess the quality or structural characteristics we desire. Trade execution continues to be good, but the process is taking longer than it did a few years ago.

- **Headline Risk Continues**

News reports suggesting severe municipal credit disruptions have diminished, but have not gone away. A report issued in early March by Roubini Global Economics forecast municipal defaults of $100 billion over the next five years. Any such estimate is, at best, an imprecise guess. However, assuming that it proves to be correct, $100 billion represents approximately 3.45% of the $2.9 trillion outstanding municipal securities. Spread over five years, it would account for 0.69% of the market per year. Most defaults in recent years have been in housing, health care and non-essential service enterprises such as solid waste disposal facilities (credits that we avoid). Almost all were non-rated or poorly rated. Additional problems in these areas would not be surprising but by no means a systemic problem. As the Roubini report indicated, defaults are likely to remain isolated events.

Municipal governments will continue to face operating budgetary challenges for some time but most are dealing with the situation responsibly with service cutbacks, user fee increases, selected tax hikes, employee reductions, unpaid days off, etc. There has been evidence of increased revenue collections in recent months and we anticipate continued improvement as the economy strengthens. The process is likely to be slow, but hopefully the trend will continue.

Our credit selection continues to focus exclusively on sound general obligation credits with growing or stable populations, high median income levels, good tax collections and diversified tax bases along with essential service revenue enterprises (e.g. water and sewer, electric utilities) with efficient operations, good customers and adequate debt service coverage ratios. Bond issued by strong university systems (recognized private institutions and large state schools) are also used.

- **Municipal Pension Reform?**

The State of Wisconsin has been in the forefront of the news in recent weeks as Gov. Scott Walker's proposal to significantly alter public employee bargaining rights and pension benefits caused a huge backlash with demonstrations in the capital and an exodus of Democratic representatives to Illinois to reduce the size of the Legislature below the number needed for a quorum. Besides demonstrations,

unions have responded with threatened boycotts of businesses supporting the Governor's efforts, potential recalls of representatives and court challenges.

While Wisconsin has commanded front page coverage, similar efforts in New Jersey, Indiana, Ohio, Maryland and numerous other states reflect a growing struggle to rein in public pension obligations. Efforts vary from state-to-state, but encompass plan revisions for new employees, shifts from defined benefit to defined contribution plans, requirements for larger worker contributions to pension and health care plans, limitations on early retirements, restrictions on bargaining rights, wage caps, enacting right to work laws, allowing workers to opt out of paying union dues, etc.

It is estimated that public pension plans are underfunded by $1 trillion and possibly by a much larger amount if lower expected return assumptions are used. Economic growth and further gains in equity prices will moderate the funding shortfall, but are unlikely to solve the problem. The ratio of retirees to active employees is expected to rise further in coming years as retiree longevity increases. How these conflicts sort out remains to be seen, but it seems evident that current trends cannot be sustained. We anticipate messy political debates and periodic judicial intervention, but feel that the trend towards reduced employee benefits and bargaining right limitations will continue and spread.

- **Financial Reform Proposals in Washington**

Rep. Paul Ryan, Chairman of the House Budget Committee, has put forth a sweeping proposal to significantly reduce the federal work force, lower corporate and personal tax rates, reform Medicare and grant states additional latitude in managing Medicaid programs. His stated goals are to reduce federal government spending to about 20% of GDP and stimulate growth by lowering tax rates. A Senate bill sponsored by Sens. Ron Wyden and Dan Coats would set personal tax rates at 15%, 25% and 35% and abolish the alternative minimum tax. Their bill would also eliminate federal tax exemption for new municipal securities. Investors would receive a 25% credit on taxable municipal interest. Rep. Ryan's proposal is silent on the issue of tax-exemption, but he is said to favor many of the proposals presented last year by the President's National Commission on Fiscal Responsibility and Reform. The Commission's report called for broadening the tax base and also recommended eliminating the tax exemption on new municipal bonds.

Nothing is likely to be decided any time soon and neither of these two proposals will survive without major adjustments. However, the question of how large the federal government should be and how it should be financed is now on the table and will likely be a central issue in the 2012 Presidential election. Broad financial reform will not be contemplated prior to the next administration assuming office, if then.

Municipal government officials are sure to argue forcibly against any changes that might result in higher financing costs. The Government Finance Officers Assn. has already cautioned that Congress should be very careful about changing a fundamental component of state and local governments' infrastructure financing. The debate is sure to be long and incorporate twists and turns. We will monitor developments.

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