The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

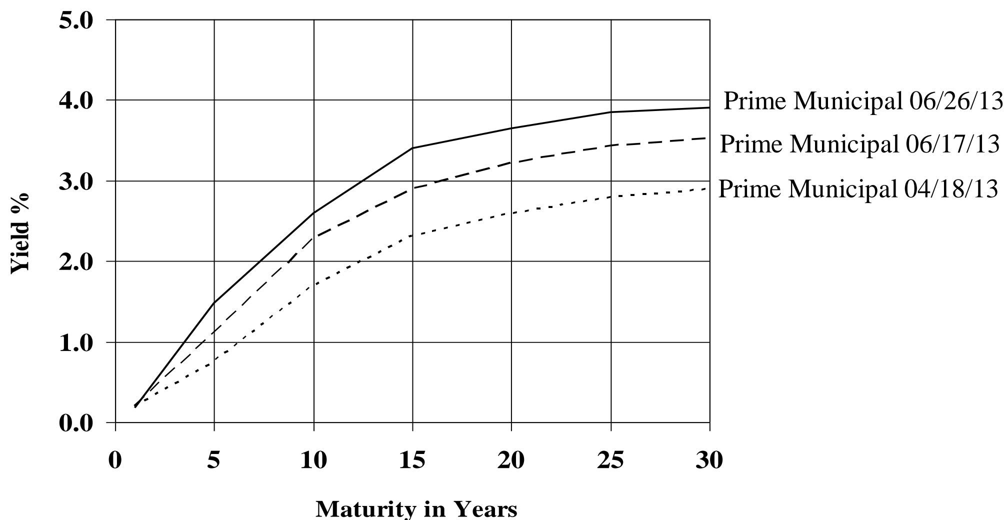
Investment Managers Specializing in Tax-Exempt Municipal Securities

JULY 2013

- **Eyes on the Fed**

The June Federal Open Market Committee meeting minutes indicated that the Fed is viewing the economic outlook with a bit more optimism and Chairman Bernanke stated that the central bank's $85 billion monthly purchases of Treasury and mortgage backed securities could be moderated later in the year. Both the fixed income and equity markets reacted to the potential withdrawal of liquidity support swiftly and negatively. The ten year Treasury yield jumped by nearly forty basis points after the Chairman's comments and traded at the 2.60% level before falling modestly. The rate increase in the less liquid tax-exempt municipal sector was even more dramatic, a surge in ten year yields of over 50 basis points. In the equity market the S & P fell by close to 5% before recovering. The recent rate spurt is a continuation of the uptrend that has been in place since late April when the yield on the ten year Treasury dipped below 1.70%. The chart below illustrates the recent shift in the prime municipal yield curve and the adjustment since April.

Municipal Yield Curve Shifts



We are now starting the fifth year of recovery since the recession ended in mid-2009. Assisted by recurring quantitative easing programs, economic momentum appears to be building modestly with energy production, auto manufacturing and housing showing degrees of strength. However, overall growth remains substandard with real growth in the 2.5% area. The unemployment rate, the Fed's key policy barometer, has been moving only grudgingly lower and remains at an unacceptably high 7.6 % level. The economy may continue to strengthen in the coming months, but a growth surge sufficient to significantly lower the unemployment rate does not appear likely. Concluding that Fed support will diminish quickly and significantly seems premature.

Municipal mutual fund redemptions forced fund managers to liquidate securities in recent weeks to meet withdrawal demands which compounded the pressure on the tax-exempt sector. Prime municipals are now out

yielding Treasuries throughout the yield curve. The municipal market is attractive on a relative basis as reflected in the following table.

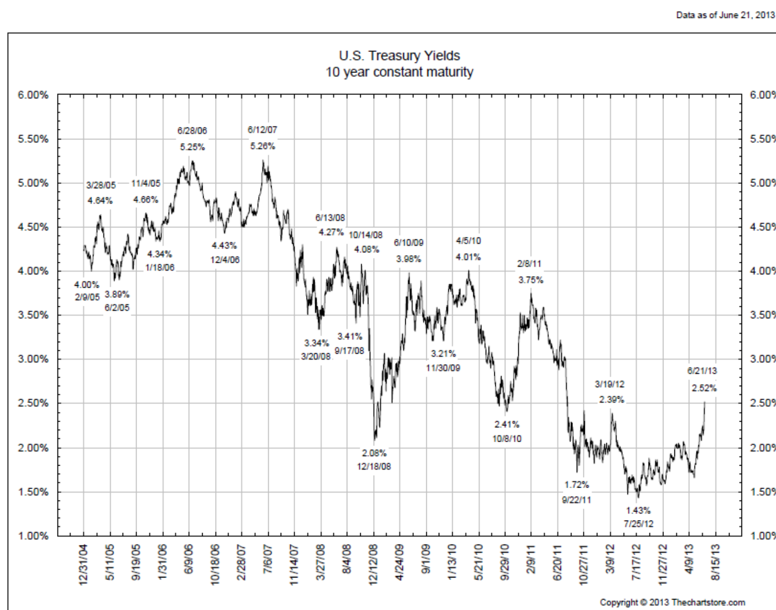
	Treasury Yield	Prime Municipal	Ratio
1 yr	0.16%	0.18%	113%
3 yrs	0.69	0.83	120
5 yrs	1.43	1.48	103
7 yrs	1.98	1.99	101
10 yrs	2.55	2.60	102
20 yrs	3.27	3.65	112
30 yrs	3.58	3.90	119

We have maintained lower than normal durations in the Traditional portfolios we manage for the last three years in response to the Fed induced low rate environment. The recent surge in rates, coupled with increased volatility and lessened liquidity, is providing opportunities to purchase high quality bonds at very attractive levels. We are purchasing ten to fifteen year maturity bonds with good call protection at nearly 100 basis point higher yields than had been available a few months ago. In the process, we are extending portfolio durations to near neutral at four years, up from the 3.6 year target we had maintained. Still conservative, but not as defensive as we have been.

- **Risk of Still Higher Rates**

Given the grudgingly slow rate of decline in the unemployment rate, our base assumption is that the Fed will continue their quantitative easing program for many more months. Mr. Bernanke reiterated the Fed's 6.5% unemployment rate target before altering the rate of QE bond purchases. Getting to that level will take time. He further reaffirmed that short rates would remain low into 2015. The Fed's continuing support should limit additional near term rate increases, especially since inflation appears likely to remain docile in the current environment where wage pressures are all but non-existent.

Still, we remain cognizant that bond vigilantes could reemerge if/when real GDP edges up above three percent or there is a hint of inflation. As shown in the chart below, a move in the ten year Treasury yield back to perhaps 3.5% to 4% would not be inconsistent with where rates were just a few years ago.



To quantify potential downside risk from current levels, assume that the ten year Treasury yield moved back to 4% at the end of next year – an eighteen month horizon. Assume also a more settled municipal market with prime tax-exempts trading at 90% of like maturity Treasury yields. The resultant taxable/tax-exempt spread narrowing would moderate the yield advance on municipal securities relative to the Treasury sector. To use a specific example to assess risk, we recently purchased Seattle, WA Wastewater 5% bonds due in 2026, with a ten year par call, at a 3.60% yield to call. The dollar price of the bond was 111.67. With a narrower spread and a yield decline due to the curve roll down, this bond would be priced at about 4% yield to call at the end of next year, resulting in a dollar price of 107.15. The resultant principal decline (from a reduced amortized cost basis) would be offset by the 7.5% coupon income received during the period (5% X 1.5 years) resulting in an approximate total return of about 3.0%. Assume further that we sold the bonds at the reduced price during this horizon period to generate a tax loss, and replaced them with similar high quality securities. A short term loss, with the capital gains rate at 39.6%, would provide an additional 1.2% positive impact (not including potential state tax benefits). Annualized total return in this "worst case" scenario would be 2.72%.

- **De Minimis Risk Emerges**

We have commented at various times about the price risk related to low coupon bonds in a rising rate environment. To review, current tax law allows a very modest gain on a bond purchased at a discount to be taxed at the long term capital gains rate. However, the price accretion on a bond purchased at below the de minimis threshold is subject to taxation at ordinary income tax rates. The de minimis threshold price is determined by multiplying a bond's remaining years to maturity times one quarter point per year. For a five year bond the de minimis price is 98.75, for a ten year bond 97.5, etc. A buy and hold investor who purchases bonds near par and holds them to maturity is not subject to the tax, whereas a subsequent purchaser of discount bonds is subject. However, the buy and hold investor may still be unnerved to see drastically lower prices on his custodial statement after rates rise.

There are numerous examples of 2% coupon bonds maturing in 2018 to 2020 that were trading above par a few months ago and are now being priced at about 94. A Maine Municipal Bond Bank new issue that sold in April provides a more dramatic example. The bonds, rated Aa2/AA+, were structured with a 3.125% coupon and mature in November 2029. They were priced at an original discount to yield 3.29% (97.916 dollar price). Bonds recently traded in the last few days as low as 77.36 – Yikes!

Our bond selection process focuses on using only high coupon bonds that provide insulation from de minimis and a cushion effect in a rising rate environment.

- **High Yield Severely Impacted**

It was reported that as of late June, the bonds tracked in the Standard & Poor's Municipal Bond High-Yield Index had a negative 7.08% month-to-date return, the worst month since December 2008 when the index returned negative 9.12%. Longer maturities and widening credit quality spreads were critical factors that triggered this performance.

A focus on high quality securities with limited duration exposure is necessary to avoid the dramatic price volatility that is characteristic of the high-yield sector.

- **Money Market Fund Reform**

The Securities and Exchange Commission voted unanimously to propose significant reforms for money market funds to limit the risk of runs on the funds during periods of economic stress such as The Reserve Fund experienced a few years ago when the Fund's holdings of Lehman Brothers securities caused it to no longer be able to maintain a constant dollar value. Given the strong support by the Commission, it is anticipated that a form

of the proposal will be adopted although significant amendments from the initial proposal are possible after industry comments are received by the Commission.

The proposal defines two types of non-U.S. government funds, institutional and retail. Institutional funds are those that provide sweep capability for pension funds, endowments, large money managers, etc. These funds would no longer be able to maintain a constant one dollar unit value but would be required to price fund assets daily and value admissions and withdrawals at the actual fund unit value using four decimal places (e.g. 0.9996, 1.0012, etc.).

Retail funds, applicable to individual investors, would be allowed to maintain a constant dollar value, but with altered accounting procedures and new restrictions. A key restriction would be to limit any one investor's withdrawal to $1 million on any business day unless advance notice is given. Another key requirement, in additions to credit quality and diversification rules, would be the maintenance of a minimum of 15% of fund assets in weekly liquid investments. Should the level of weekly liquid assets fall below 15% of total fund assets, fund trustees could impose a 2% liquidity fee on withdrawals or suspend withdrawals. Such restrictions would be automatically lifted when weekly liquid assets rose to 30% of fund assets.

It is being proposed that municipal funds fall under the government fund umbrella and not be subject to the restrictions outlined above. What changes are ultimately instituted remains to be seen, but investors need to be aware of possible changes in the manner that custodian money market funds are managed. We will monitor developments.

- **Bankruptcy in Detroit?**

Years of decay in Detroit have left the city with less than half its former population, abandoned houses and a decayed infrastructure. The worsening situation prompted Gov. Rick Snyder to appoint Kevyn Orr as the City's Emergency Manager. After his review, Mr. Orr, in an opening gambit, has proposed that the City's creditors, including bondholders, accept dramatic haircuts on outstanding obligations. Creditor response to the proposals has not been supportive which suggests that a bankruptcy court may be the only possible arbiter that can balance competing claims. How bondholders fair in these proceedings remains to be seen and may, as with the Stockton and San Bernadino, CA bankruptcies, establish precedent regarding bondholder rights in Chapter 9 proceedings. We have never invested in Detroit bonds. Still, this situation represents an extreme case of a challenged credit and highlights the need for professional credit oversight in selecting municipal investments.

- **Firm Update**

We regret to announce that after twelve years, Kim Lundgren has decided to explore career opportunities at another firm. She will be missed by the C.W. Henderson family, but we wish her great success.

Craig W. Henderson　　　　　　　　Thomas L. Mallman CFA

This newsletter may contain material received from outside sources that we consider reliable. However, no representation is made to its completeness or accuracy.
C.W. Henderson & Associates, Inc. All rights reserved.