The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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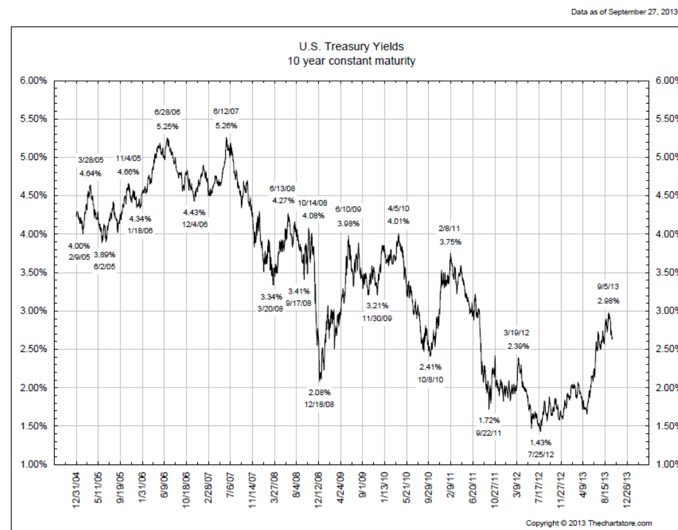
Background and Outlook

There's certainly no lack of uncertainty facing investors. Congressional wrangling over the budget that will soon to be followed by debt ceiling negotiations currently lead the list followed by whether the Fed will begin tapering any time soon. If so, by how much? The two issues are, of course, closely related with the Fed concerned that a monetary policy shift could be damaging while fiscal policy is stagnating. Further down on the list is who will be nominated as the next Federal Reserve Chairperson now that Larry Summers has bowed out? Will monetary policy be altered under new leadership? Will Chairman Bernanke's attempt to provide transparency be curtailed or expanded? Are conditions in the Middle East improving or is this a lull before the next eruption? The list goes on.

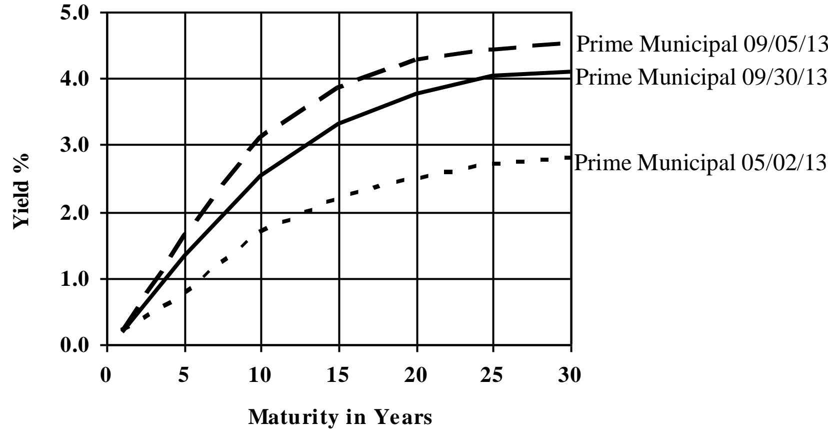
Adding to the uncertainties listed above is the impact of the Affordable Care Act. Will firms with under fifty employees limit hiring to avoid increased compliance requirements? Will the use of temporary employees increase? To what extent will health care costs be shifted from employers to employees? How will the overall cost and availability of health care be impacted? Best guess is that the Act will have a marginal negative impact on hiring and disposable income.
Despite the turbulence, the economic fundamentals appear to be tracing a fairly steady course with moderate growth, limited inflation and a still high unemployment rate that has declined at a grudgingly slow pace. A continuation of real GDP growth in the 2% area with inflation in check seems likely over the foreseeable future.

As noted in last quarter's newsletter, Chairman Bernanke's comment last spring that the Fed's $85 billion per month of Treasury and agency securities purchases could be tapered this fall caused yields on longer maturity securities to jump, almost instantaneously, by forty to fifty basis points. In the case of the ten year Treasury the move started from the 1.66% interim low reached in May. This initial move was followed by additional rate increases through mid-September that resulted in an intraday peak rate of over 3% on the ten year government. The Fed's subsequent announcement after the September FOMC meeting that tapering was not yet in their game plan prompted a rally during the closing weeks of last month. The yield on the ten year Treasury closed September at 2.64%. The following chart illustrates recent interest rate movements.



Rate swings in the municipal sector followed the lead of the Treasury market. The chart below illustrates the shift in the prime tax-exempt yield curve since early May.

Municipal Yield Curve Shifts



The sharp upward yield adjustment during the summer prompted some investors to reduce their fixed income holdings. Bond funds have been especially hard hit. Outflows from municipal bond funds have persisted for the past eighteen weeks and, in aggregate, redemptions have exceeded $40 billion. Municipal fund sales slowed significantly in recent weeks but have not stopped.

Higher rates prompted us to extend targeted portfolio durations modestly from the conservative 3.6 year level we had maintained for many months to near 4.0 years – still slightly below neutral. This action proved to be beneficial as most bonds purchased a few weeks ago are now trading at higher prices in response to the recent rate decline. We are currently maintaining the extended duration target. The availability of high quality bonds with structural features that we utilize has been limited by reduced new issue supply that is now estimated to total approximately $325 billion this year, down from about $375 billion last year. Our portfolio positioning is also influenced by the fact that longer tax-exempt yields now provide positive real returns relative to expected inflation levels as well as very attractive taxable equivalent returns.

Rate Volatility Likely To Persist

Given the uncertainty surrounding the government shutdown and looming debt ceiling debate, we expect that the fixed income markets will continue to be volatile. Also overhanging the market is the fact that the Fed, despite the recent reprieve, will ultimately have to taper. Action by the Fed may be delayed for a still significant period of time, but accommodation will ultimately be reduced. Another rate spurt is possible when this happens. Volatility is also being affected by reduced market liquidity. Lower capital allocations to trading desks have caused dealer inventories to be pared and bid/ask spreads to widen. All fixed income markets have been impacted but the effect is amplified in the municipal sector where hedging is extremely difficult due to the vast array of over a million CUSIPS and existence of basis risk in possible hedging strategies. The good news is that volatility provides opportunities that can be taken advantage of by active managers. Duration adjustments, tax loss harvesting, capitalizing on rich/cheap sectors of the market, etc. have the potential to provide return enhancements.

Detroit Struggles to Develop a Workout

The loss of a quarter of the Detroit's residents and a 40% decline in income tax receipts since 2000, coupled with a drop in state aid, pushed the City to the brink and prompted Gov. Rick Snyder to appoint Kevyn Orr as Emergency Manager. Mr. Orr has been tasked to develop a plan that will restructure the City's debts, restore services and establish a path to long term viability.

The Emergency Manager's actions have focused on reducing the City's $18 billion liabilities which include an estimated $9 billion in bond, loan and related debt. In addition, the pension plan is seriously underfunded and there are insufficient funds for current employee and retiree health care expenses. Mr. Orr had hoped to quickly develop and implement a workout plan. Given that this is the largest municipal bankruptcy of record and numerous interests are vying for a share of the pie, we anticipate a lengthy and expensive proceeding. Major issues that are in play include:

- Are Detroit's municipal workers' pension benefits guaranteed under the State constitution? If not, how much can they/should they be reduced? If the plans are constitutionally protected, can they be negotiated lower? Pension underfunding is estimated to be $3.5 billion.

- Five bond insurers (Assured Guaranty, Ambac Financial, Financial Guaranty, MBIA and Syncora) are subject to claims on $6.55 billion of Detroit bonds. How tenacious will they be as they work to limit debt service impairment and protect their capital bases?

- What is the City's "willingness to pay" in regard to unlimited tax general obligation bonds – especially those that were voter approved?

- Where will OPEB health care claims (which aren't on the City's balance sheet) rank in the lineup of creditor demands? On the same level as ULTGO debt?

- Can Detroit's Water and Sewer debt (which is self-supported) be restructured to capture excess system revenues for use by the City?

The complexity of the situation and the number of claims appears certain to extend the length of the workout. It has been reported that Washington provided Detroit with $300+ million of assistance. This is meaningful, but clearly not sufficient to rescue the City. As we have indicated before, we have never purchased Detroit securities. However, the magnitude of the bankruptcy and the potential impact on other segments of the municipal market require us to closely monitor developments. The spillover effect of Detroit's bankruptcy on the valuation of the many high quality Michigan credits being a case in point.

Puerto Rico Bonds Under Pressure

Issues similar to Detroit are also plaguing Puerto Rico. The island territory with a current population of 3.8 million has had negative growth since 2006 and is dealing with outmigration, a 13+% unemployment rate, and a high poverty level. Government employment accounts for about 25% of all jobs and transfer payments make up 40% of personal income. Puerto Rico has $70 billion debt outstanding and $30+ billion of unfunded pension liabilities. Gov. Padilla, who was elected last November, is attempting to improve conditions by cutting government payrolls and increasing tax collections.

We have also never purchased Puerto Rico securities. We do however find that Puerto Rico bonds are often included in portfolios we receive that are funded with existing securities. We liquidate these positions as soon as it is practical to do so. The Commonwealth's bonds are viewed favorably by some investors due to their high relative yields and the fact that the income they provide is exempt from federal, state and local taxation. As a result, many single state municipal mutual fund portfolios have historically held large Puerto Rico bond positions.

Yields on Puerto Rico securities rose sharply this past month as credit concerns intensified. At one point a block of the Commonwealth's Baa3/BBB- general obligation 6.50% bonds due in 2040 traded at a 10.08% yield. Yields on Commonwealth bonds subsequently declined, but continue to trade at significantly wide spreads.

Has the Perception of Risk in the Municipal Market Changed?

Vallejo, Stockton and San Bernardino in California along with Harrisburg, PA and Detroit have all encountered financial challenges. In each instance heavy debt loads, rising operating expenses, unfunded pensions, post-employment health care costs, etc. rose to unsustainable levels such that basic services could not be maintained while also supporting these other obligations. As municipal officials have sought remedies in these situations there appears to be a somewhat greater willingness to adopt a "spread the pain" approach and a diminished "willingness to pay" in regard to outstanding obligations. In such cases Chapter 9 bankruptcy restructuring can have appeal.

Is severe financial strain prevalent and will many additional municipal restructurings take place? We feel this is very unlikely. Most municipalities continue to be managed well with expenses held in check and budgets in reasonable balance. Severe credit stress is likely to remain isolated. It should also be noted that bankruptcy is not an option in many states and in most states where it is allowed, it cannot be pursued without state approval. Heavy legal expenses and protracted timeframes before court resolutions are finalized also act as deterrents. Municipal officials also realize that post-bankruptcy capital market access is certain to be limited and very expensive.

Still, the environment demands judicious credit selection and continuous portfolio monitoring. This activity is a fundamental component of the C.W. Henderson investment process.

Firm News

We are pleased to announce that Ashley Courtney has joined C.W. Henderson & Associates as the Firm's Office Manager. She will assure that infrastructure needs of the Firm are attended to and also provide support for the Operations Group and assist marketing efforts. Ashley is a recent Purdue University graduate where she was a member of the women's intercollegiate softball team. Welcome aboard.

Craig W. Henderson　　　　　　　　　　Thomas L. Mallman CFA

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