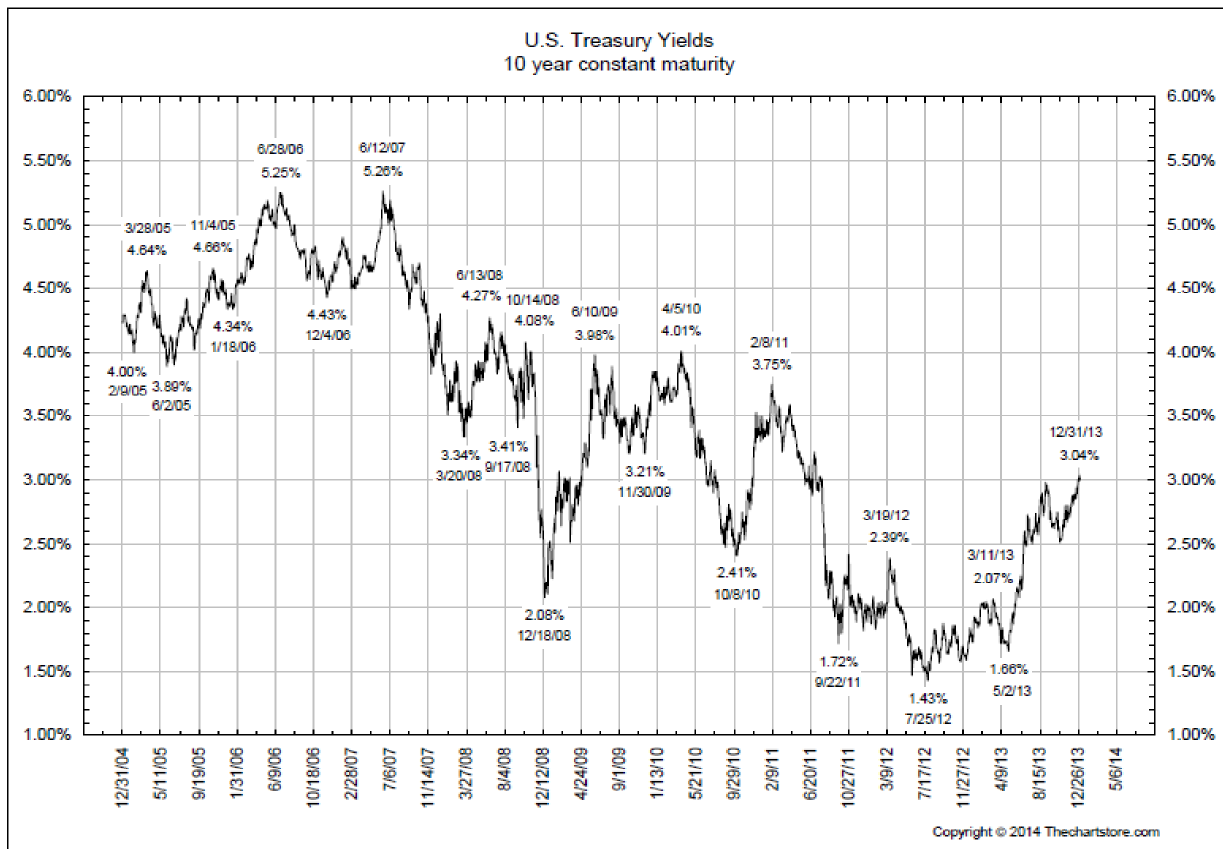
December 31, 2013

Interest Rate Outlook

The economic backdrop appears to be improving modestly with declines in the unemployment rate, a pickup in manufacturing, strength in auto sales, improving home prices, increased exports, etc. Also brightening the picture is the Congressional budget agreement negotiated by Rep. Paul Ryan and Sen. Patty Murray that forestalled another governmental shutdown. The improving environment prompted the Federal Reserve to announce that they would begin scaling back their $85 billion monthly quantitative easing purchases of Treasury and mortgage backed securities. In contrast to the surge in rates last spring and summer when Chairman Bernanke indicated that tapering was being considered, the market largely took the most recent announcement in stride. The ten year Treasury yield has risen to the 3% area, up about 35 basis points from the beginning of the fourth quarter, but it appears that this move largely reflects the improvement in the economic outlook rather than the Fed's planned tapering. The following chart depicts the path of ten year Treasury yields over the past several years and illustrates the rate increase experienced since the 1.66% low was reached in early May of last year.

Data as of January 3, 2014



Are rates poised to move sharply higher in 2014? We do not think so. A moderate rise from current levels seems possible, but a dramatic increase does not. While gaining some momentum, the economy is not moving forward at warp speed. Still high unemployment, limited wage growth and constrained governmental spending, both at the federal and state and local levels, are acting as retardants. Real growth trending towards 3% seems a likely prospect, still a slow recovery by historic standards.

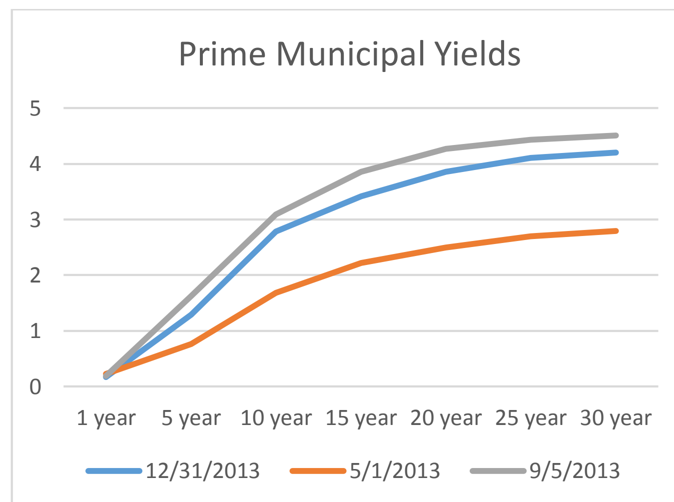
With inflationary pressures expected to remain subdued and longer bonds now providing real returns, this does not suggest an environment that is likely to produce significant near term rate pressure.

Two significant uncertainties prevail. The first is the debt ceiling that will be confronted early this year. Given the success of the recent budget negotiations, we are optimistic that this will not present a serious road block. More important will be Federal Reserve policy. Incoming Chairperson Janet Yellen will be tasked with implementing the tapering program. We expect it will move forward as planned with little difficulty. Despite this policy adjustment, monetary accommodation is expected to be maintained with short rates remaining near zero. The Fed's balance sheet currently exceeds $4 trillion, up from under $3 trillion at the start of last year, and is poised to move somewhat higher until QE buying ceases. No reduction in the size of the Fed's expanded balance sheet is anticipated until substantially stronger economic growth develops and/or a pickup in inflation is experienced that warrant a reduction in the level of excess bank reserves. Such action is not anticipated in the next year or two, but probably will be at some point. A deft hand will be needed to manage this process effectively when it is required.

With the potential for rates to perhaps move somewhat higher, we once again feel that a moderately cautious posture is appropriate and portfolio durations are again targeted at 3.6 years. Adjustments will be made as needed should there be changes in the economic outlook and/or Federal Reserve policy.

2013 Municipal Market Review

Fed accommodation during the past year kept short rates near zero as they have been since late 2008. This action continued to limit the returns realized on the short components of the barbell constructions we employ. Longer tax-exempt rates drifted lower during the early part of 2013 and reached the lows for the year in early May in concert with the Treasury market. Low nominal and real rates at that time prompted us to target portfolio durations at 3.6 years, about 15% below neutral. Somewhat stronger economic growth coupled with Chairman Bernanke's remarks that QE tapering was being considered caused a sharp jump in rates during the spring and summer months. Ten and thirty year prime yields moved respectively higher by about 140 and 180 basis points. We took advantage of the resultant decline in bond dollar prices and captured available capital losses. Proceeds from these sales were used to purchase longer securities and lock in then prevailing higher yields. In the process portfolio durations were extended to about four years. As rates subsequently retreated in the fall we scaled back durations to increase defensiveness. The following prime yield curves reflect the highs and lows for the year along with yearend rates levels.



The sharp rate increase from an extremely low base and steepening yield curve from early May to September impacted longer maturity bond dollar prices and many accounts experienced negative total returns during this period. For the entire year the C.W. Henderson composite had a modest, less than a half of one percent, negative total return before fees. The first negative annual return in the almost twenty-three year history of the firm. However, the tax savings that most accounts accrued from our tax loss harvesting (which is not quantified), provided a significant offset to the reported negative returns.

2014 Municipal Market Outlook

We anticipate a more attractive environment this year. We do not expect that rates will move significantly higher over the near term given the background of moderate economic growth and the availability of positive real returns on longer maturity bonds. A moderate rise in the ten year Treasury yield to perhaps 3.5% seems possible. Assuming a ten year prime tax-exempt to Treasury yield ratio of 95%, the resultant tax equivalent yield on high quality municipal securities will be compelling for high income investors. The high coupon securities we utilize will provide even higher taxable equivalent comparisons. We anticipate growing retail demand for tax-exempt income as the year progresses.

Municipal mutual fund outflows were large and persistent last year with withdrawals totaling over $70 billion. Selling intensified in the closing weeks of the year as investors captured tax losses. We expect that fund liquidations will moderate in the coming weeks which should provide some stability to the long end of the market. Also arguing for an improved technical picture is the limited new issue supply that is now forecast to be under $300 billion this year, down from approximately $330 billion last year and dramatically below the record $433 billion bonds marketed in 2010. With many municipal operating budgets still under pressure new infrastructure projects are likely to remain limited. In addition, the rise in rates has diminished the viability of refunding issues which will further limit new issue volume this year. We anticipate that new issues will, for the most part, find ample demand in 2014.

On the flip side, secondary market liquidity is expected to remain constrained. Restrictions stemming from Graham Dodd legislation and the Volcker Rule, that are designed to limit financial institution risk (e.g. the London Whale), will restrict the ability of dealer trading desks to take on bond positions without having identified buyers. Certain municipals are exempt from the legislative restrictions, but heightened institutional risk aversion is likely to impact all trading desks. Wider than normal bid/ask spreads and volatility in the secondary market are expected to be part of the landscape as the year progresses. This environment has the potential to provide trading opportunities that can benefit our clients.

Detroit Bankruptcy Clouds Outlook for Pensions

Judge Steven Rhodes, who is presiding in the Detroit bankruptcy, ruled that public employee pensions are a contractual right and not protected, even though the Michigan Constitution expressly provides such protection. In essence, he ruled that federal law has precedence over state law in a Chapter 9 proceeding. This blazes a new trail. Challenges are sure to be forthcoming and the ultimate outcome remains to be seen.

If this precedent is established there is likely to be follow through in other situations. The Vallejo, Stockton and San Bernardino bankruptcies in California did not attempt to challenge the CalPers assertion that pension obligations are sacrosanct in California and municipalities cannot opt out of their obligations. Might a different California municipality be emboldened by the Detroit proceedings in the future? Might municipalities in other sections of the country use Detroit as leverage to modify their pension plans?

While not related to Detroit, the State of Illinois enacted long needed pension reform legislation that includes increases in the eligible retirement age, suspension/decreases in annual cost of living adjustments, a cap on salaries used to calculate pension benefits and a voluntary option for some employees to move to defined contribution plans. Decreases in employee contributions and a funding guarantee by the State provides a degree of offset. Public union lawsuits challenging the law are anticipated based on the Illinois State constitution that explicitly states that public worker pensions are considered enforceable contractual relationships and benefits cannot be diminished or impaired. A lengthy and possibly contentious challenge process is anticipated. Movement by the state could prompt the City of Chicago and Cook County to also take action to alter pension plans.

Pension plan adjustments seem all but certain to become more prevalent as the budgetary burdens related to the demographic reality of rising retiree to worker ratios and increased retiree longevity become more pronounced. Postemployment benefit commitments are restricting the ability of some municipalities to provide basic education, police, fire, etc. services to constituents. The only question seems to be how wide spread this trend will become.

Assessment of pension plan integrity is an important component of the C.W. Henderson credit review process. Only credits that have reasonably well funded plans are approved for use in client accounts. The funding of other postemployment benefits, e.g. health care, is also reviewed along with our analysis of general operating fund soundness. Credit stress has not gone away. It is imperative that high credit quality standards be maintained.

Puerto Rico Update

The Commonwealth's fiscal problems remain prominent in the news with reports of continued outmigration from the island to the U.S., lack of economic growth, tax collection shortfalls, etc. Moody's and Fitch have both warned that downgrades to below investment grade are possible. With $70 billion of debt outstanding, Puerto Rico securities are held widely by individual investors and in mutual fund portfolios due to the relatively high yields and triple tax-exempt income that these bonds have long provided. Dollar prices of Puerto Rico securities dropped precipitously over the past several months as credit concerns intensified and yields on all but very short maturity instruments are close to 9%. Downgrades could force yields even higher in response to forced sales by accounts not authorized to hold below investment grade securities. We have never purchased Puerto Rico securities in the past and always expeditiously liquidate Puerto Rico bonds that are included in portfolios of new accounts funded with existing securities.

Firm News

As we begin 2014 we extend our best wishes for health and prosperity in 2014 to our clients, business partners and friends. We are extremely grateful for the confidence and loyalty expressed by our clients and for the solid business relationships that assist us in providing high quality investment management services. We wish you all a Happy New Year.

Craig W. Henderson　　　　　Thomas L. Mallman CFA

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