The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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Background and Outlook

The year opened with the ten year Treasury yield above 3%, having risen by about 35 basis points during the fourth quarter of last year. With the economy gathering a degree of momentum and the Federal Reserve's tapering program in place, the consensus view at that time was that interest rates would continue to move higher in 2014. That was not the case in the first quarter. By early February longer Treasury rates had dropped by about 40 basis points and subsequently traded in a narrow twenty basis point range for the remainder of the quarter. The ten year Treasury yield closed the period at 2.73%. The rate decline was influenced in part by a flight to quality in reaction to anxiety over the Middle East and Crimea and, perhaps to a greater extent, signs of slower global growth (e.g. China) and uncertainty regarding the impact of the frigid winter on the U.S. recovery. Investors' favorable view of the fixed income markets has been also influenced by docile inflation with year-over-year price increases running well below the Fed's 2% target. Economic momentum should build as the weather warms with real GDP advancing at perhaps a 3% pace. A move in longer interest rates to modestly higher levels would not be surprising in this environment, but we do not expect dramatically higher yields.

Janet Yellen assumed the mantel as Fed Chairperson in January and is following the path of her predecessor. Tapering remains on target with QE purchases of Treasuries and mortgage backed securities scheduled to end later this year. Ms. Yellen has emphasized that short rates will remain low and Fed policy accommodative until unemployment declines to "an acceptable" level. She implied that a move to higher rates will ultimately be necessary, but also stated that the labor market weakness will require Fed accommodation well into the future. Forward rates suggest that a Fed Funds rate increase is unlikely until perhaps the latter part of 2015.

The municipal market, as usual, followed the lead of the Treasury sector during the past quarter but has also been influenced by concerns regarding Detroit and Puerto Rico and, perhaps of most significance, limited new issue supply. Volume in the first three months totaled about $62 billion, a 26+% decline compared to the first quarter of 2013. Individual investors scrambled to invest coupon receipts and principal maturities in this low volume environment while municipal mutual fund managers finally experienced a few weeks of modest inflows after months of hemorrhaging. With limited supply, the typical March, April selling pressure caused by investors raising funds for tax payments has not been significant this year.

We anticipate that supply will increase modestly as the year progresses, but total less than $300 billion for the year, a dramatically reduced level compared to the $433 billion issuance as recently as 2010. Limited supply while demand for tax advantaged investments remains firm should temper moves to higher rate levels in the municipal sector. Still, we remain cautious given the low levels of nominal rates, especially in the short segment of the yield curve where real returns are minimal and tax-exempt/Treasury yield ratios are low. The five year prime municipal is yielding only about 73% of the like maturity Treasury rate despite a 30 basis point rise in rates in this segment of the tax-exempt yield curve in March. The following table details the movement in prime tax-exempt yields over the past quarter and illustrates the decline in longer rates.

	3/31/14	3/05/14	12/31/13
1 Year	0.15%	0.14%	0.17%
5 Years	1.31	0.99	1.29
10 Years	2.51	2.42	2.78
15Years	3.12	3.01	3.42
20 Years	3.39	3.37	3.86
30 Years	3.68	3.68	4.20

Portfolio durations are targeted at about 3.5 years, 15+% below neutral. The barbell portfolio structures we employ with durations clustered under a year and in the eight to nine year area serve to dampen the negative impact of rate increases, especially in an environment where rising rates are accompanied by a flattening yield curve. These arrangements performed well during the latter part of the past quarter.

Puerto Rico's $3.5 Billion Sale

Investor focus on the Commonwealth's finances and heavy level of outstanding debt intensified during the early part of the quarter, especially after it was announced that a new debt financing was planned. As preparations were being made for the sale, S&P lowered Puerto Rico's rating in early February to BB+ (junk). The downgrade was not surprising given the Commonwealth's challenges and S&P's move to non-investment grade was quickly followed by Moody's and Fitch.

The downgrade caused Puerto Rico debt to be removed from the Barclays Investment Grade Index resulting in a 2.5% reduction in the size of this benchmark. Many mutual funds with limits on non-investment grade holdings are now precluded from purchasing more of the Commonwealth's securities. With much of the traditional marketplace closed, distribution of new debt had to rely on non-standard municipal buyers: hedge funds, cross-over buyers, foreign buyers, etc.

The sale went forward in early March with a contemplated size of $3 billion. The bonds were structured with 8% coupons, a 2035 maturity, six years of call protection and priced at $93.50 to yield 8.72%, below the yield levels Puerto Rico bonds had been trading. A mandatory sinking fund starting in 2021 reduces the average life of the bonds to sixteen years. Strong demand prompted Commonwealth treasury officials to increase the size of the issue to $3.5 billion.

Getting this sale done provides liquidity and breathing room into next year, at least through the capitalized interest period. However, no one feels that Puerto Rico is out of the woods. Revitalizing the economy is paramount if unemployment levels are to be reduced, tax collections improved and out-migration stemmed. How this might be accomplished remains uncertain. We remain negative on Puerto Rican credits and expect that the Commonwealth's financial challenges will be back on the market's radar screen next year, if not earlier. Hedge funds and cross-over buyers tend not to be long term investors. If credible plans are not developed reasonably quickly, these investors could move on to new opportunities.

We will continue to monitor the situation closely. Disruption of a major debt issuer impacts the entire market as quality spreads are adjusted, other credits are scrutinized, investor anxiety is heightened, etc.

Detroit's Plan of Adjustment

Detroit's Chapter 9 bankruptcy continues to overhang the market as the City attempts to restructure $18 billion long term obligations, including $3.5 billion unfunded pension obligations and $9 billion outstanding bonds and loans. Emergency Manager Kevyn Orr is working to get buy in on debt relief and pension fund liability adjustments. Contributions totaling $800 million have been committed by the State and various foundations to preserve the City's art museum and shore up employee pension plans. City unions are being offered 6% benefit reductions and the elimination of cost of living increases while bond holder interests are being subordinated. The legality of taxable pension obligation bonds sold in the middle of the last decade is being challenged and it appears that general obligation bond holders may recover as little as 15% of their investments. What make up bond insurers can/will provide to holders of insured bonds is uncertain. Restructuring of Detroit Water and Sewer bonds is also being contemplated with a debt exchange, interest rate cram down and elimination of call protection. It has long been presumed that these special revenue securities, backed by a financially viable enterprise, would not be impacted.

The City has been authorized to borrow $120 million from Barclays Capital to purchase police and fire equipment and to raze some of the 80,000 vacant buildings in the City. The loan will be backed by pledged income taxes and future assets sales.

Negotiations and challenges will continue for some time before legal issues and various claims are settled and Judge Rhodes rules on the compensation to be provided to the various parties. Whatever the ultimate resolution, the Detroit bankruptcy raises numerous issues that could alter investor perceptions of municipal credit quality. Pertinent questions include:

- Where do bond holder claims rank relative to citizens, municipal workers, pension obligations, etc.?
- What is the value of a "full faith and credit" ad valorem tax pledge?
- How should "willingness" to pay be assessed?
- Where should health care expenses for current and retired workers rank in the priority of claims?
- Should rating agencies consider the likelihood of state support for ailing municipalities in assigning ratings?
- Should rating differentials be applied to credits in states where Chapter 9 filings are or are not allowed?
- Do special revenue backed securities (e.g. Detroit Water and Sewer) have specific protection in a Chapter 9 bankruptcy?
- Do bonds backed by statutory liens on revenues or properties have protection in bankruptcy?

When and how the Detroit bankruptcy is concluded remains to be seen. The obvious take away is that credit monitoring has become significantly more important.

Are Tax Law Changes on the Horizon?

Despite a lack of enthusiasm to consider tax reform legislation prior to the midterm elections, House Ways and Means Chairman Dave Camp recently submitted a detailed plan. It includes two tax brackets set at 10% and 25% along with a 10% surcharge for joint filers with combined incomes over $450,000. The base for the surcharge on high earners includes compensation for employer sponsored health insurance, untaxed Social Security benefits, 401(k) contributions and municipal income.
The plan also eliminates deductions for state and local taxes, limits interest deductions for mortgages up to a maximum of $500,000 (down from the current $1 million level), eliminates private activity municipal bonds and advance refundings and restricts the use of bank qualified bonds.

There are similarities to Rep Camp's proposal with the Simpson Bowles plan presented a few years ago. Like Simpson Bowles, and the President's earlier proposal to cap all deductions at 28%, this plan has no chance of moving forward in an election year when various constituents would be seriously impacted. However, the topic of tax reform seems to be on Washington's collective mind and at some point a credible attempt to simplify and improve the fairness of the tax code could surface. Including municipal income as a preference item will likely be part of the discussion.

Underlying the question of municipal income taxation is the concept of "reciprocal immunity" that extends back to the Tenth Amendment to the Constitution. Reciprocal immunity is based on co-sovereignty between the federal government and the states with cities and counties being sub-sovereigns. Under this arrangement states cannot tax income from government securities and the federal government exempts state and local bond interest from federal taxation.

State and local governments must borrow to finance infrastructure projects and provide other essential government services. Should municipal income be taxed at the federal level, the yield relationship between taxable and municipal securities would be altered causing state and local governments to incur increased financing costs. In effect, the federal government would be shifting their revenue raising challenges onto municipalities.

Despite the improbability of legislative action anytime soon, it is imperative that the situation must be monitored.

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