The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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Background and Outlook

Yields on fixed income securities fluctuated modestly during the second quarter and trended lower with the yield on the ten year Treasury falling from 2.73% to 2.53% during the period. Uncertainty regarding the strength of the U.S. economy after the sharp 2.9% RGDP decline in the first quarter combined with apprehension over the flare up in Iraq and Russian assertiveness in the Ukraine bolstered demand for safe harbor investments. Tax-exempt yields followed a similar path as investors scrambled to reinvest proceeds from income receipts and principal payments in a low new issue volume environment. The table below details the decline in tax-exempt rates and curve flattening experienced during the first half of the year.

Prime Municipal Yields

	6-30-14	3-31-14	12-31-13
1 Year	0.13%	0.13%	0.17%
5 Years	1.20	1.33	1.29
10 Years	2.26	2.55	2.78
15 Years	2.73	3.02	3.42
20 Years	3.04	3.39	3.86
30 Years	3.28	3.66	4.20

Positive economic growth returned in the past quarter with non-farm employment gains well in excess of 200,000 each month that have reduced the unemployment rate to 6.1%, near the Federal Reserve's policy reversal target level. Despite the decline in the unemployment rate, the health of the labor market remains somewhat in question with the labor participation rate under 63%, the lowest since the early 70s, and a high level of part time employment. QE tapering remains on target with the Fed purchasing $10 billion fewer Treasury and Government Agency securities each month. Ms. Yellen has indicated that accommodation will continue with short rates remaining near zero into next year.

A 2.1% year-over-year increase in the CPI in May prompted debate as to whether inflation is being rekindled. Food prices and the cost of other staples are moving higher, but wages are being held in check by the unemployment overhang which should, over the near term, limit inflationary pressures and not disrupt the Fed's game plan.

We anticipate that economic growth will continue in the coming quarters, but at a moderate pace with RGDP advancing at about a 3% rate. Interest rates will likely be range bound in this environment with the ten year Treasury, currently yielding 2.65%, trading in perhaps a hundred basis point range with a central tendency near 2.75%. As is typical, municipal yields will generally follow the lead of the Treasury market.

Approximately $125 billion new tax-exempt bonds were sold during the first half of the year with volume for the full year forecast to total about $285 billion, down from $332 billion in 2013. Some increase in supply seems likely in future years as the economy continues to gather strength and municipalities address delayed infrastructure needs. Near term, limited supply in the face of continued strong demand should temper upward rate pressures.

Despite our expectation of near term relative stability, we remain cautious. Market levels suggest a 2+% inflation rate moving forward. With the ten year prime municipal yield at 2.35%, real returns are limited. Another indication of the richness of the tax-exempt market is the ratio of prime municipal to Treasury yields which, for ten year securities, is currently at 89%, down from 95% at the end of last year and over 100% in 2013. Credit spreads are also tight with ten year BBB securities yielding a modest 115 basis points more than AAA securities. This credit spread was about 30 basis points wider at the end of the first quarter. Given these relationships and the solid returns realized by tax-exempt investors over the first half of the year, we have reduced our portfolio duration target to 3.4 years, down from our previous 3.6 year target and well below the 4+ year neutral level.

Mounting Problems in Puerto Rico

The successful sale of $3.5 billion general obligations bonds by the Commonwealth in March was expected to provide liquidity to sustain operations until at least next year. However, stress has developed among Puerto Rico's public corporations which prompted expedited legislation that provides a mechanism to restructure revenue backed debt obligations. Most prominent among the ailing public enterprises is the Puerto Rico Electric Power Authority (PREPA) which has encountered a severe liquidity crisis and is reported to be having difficulty paying for the oil needed to power its generators. PREPA has $8.8 billion bonds outstanding.

Moody's responded to Puerto Rico's legislation by dropping their rating on the Commonwealth's debt further into junk territory. All three rating agencies lowered Puerto Rico's ratings to non-investment grade (BB+, Ba2) in March. Moody's now rates Commonwealth debt at the B2 level. PREPA was lowered to Caa2, down from Ba3 while the Highway and Transportation Authority was lowered to the Caa1 level, also down from Ba3.

Franklin Templeton Investments and Oppenheimer Funds, which collectively hold $1.7 billion PREPA bonds, are challenging the legislation in the U.S. District Court in Puerto Rico, arguing that only Congress has the power to establish bankruptcy rules. Whether the court finds merit in their argument remains to be seen. Municipal bond insurers with exposure to public corporation debt have yet to step into the legal fray.

As expected, prices of Puerto Rico securities have suffered additional dollar price declines as the market attempts to assess the likely fallout from the restructuring legislation. Some uninsured PREPA bonds have traded at dollar prices in the 40s, equating to 16+% yields. While we have never purchased Puerto Rican securities, we are continuing to closely monitor the situation to assess the potential impact on the broader municipal market.

Detroit Update

Meanwhile, bankruptcy proceedings have moved forward in the motor city. Under the agreement worked out with Emergency Manager Kevyn Orr, the unlimited tax general obligation bonds will be repaid at 74% of the original par value with bond insurers providing for the remainder.

This agreed amount is significantly higher that the initially proposed 15% compensation for UTGO bonds. Pensioners will be less severely impacted. The proposed settlement provides for full pension benefits but without COLA increases.

Various lessons can be learned from Detroit's bankruptcy. The assumption that debt service has a senior claim on pension obligations and revenues needed to fund ongoing municipal operations may well be invalid in situations where fiscal stress is severe. "Full faith and credit" language may not provide the protection expected without a statutory lien on ad valorem or other specified taxes. Indenture defined support for enterprise revenue backed bonds (e.g. Detroit Water and Sewer) may also be eroded as a distressed municipality works to capture a broader array of operating revenues.

The primary take away is that high credit standards supported by in depth research must be the fundamental driver of a credit selection process. Fundamental general obligation credit factors such as population trends, tax collection history, tax base diversification, median family income, etc. must be combined with an assessment of the integrity of municipalities' pension plans and post-employment health care funding to conduct thorough credit analysis.

Volatility Risk

The decline in rates and relative stability of the fixed income markets this year has tempered the investor angst that prevailed in the spring and summer of last year when bond prices sank in reaction to the spike in rates experienced at that time. As shown in the table below, longer rates moved sharply higher with ten year Treasury yields rising by 132 basis points in the four month period from early May to start of September last year while municipals experienced similar yield increases. The dollar price impact on holdings of fixed income securities was dramatic, especially given the low rate level at the start of the backup. Many longer bonds suffered dollar price declines of ten points or more.

Comparative Yields

	May 2, 2013		Sept. 5, 2013	
	Treasury	Prime T/E	Treasury	Prime T/E
1 Yr.	0.11%	0.19%	0.16%	0.22%
5 Yrs.	0.65	0.76	1.85	1.62
10 Yrs.	1.66	1.68	2.98	3.09
30 Yrs.	2.82	2.79	3.88	4.16

The abruptness of the rate move and resultant bond price declines were unsettling to many investors. We do not anticipate a move of this sort in the near term, but the risk cannot be ignored. The next significant increase in rates may well be precipitated by Federal Reserve tightening as the economy strengthens. Increases in the Federal Funds rate will likely cause longer rates to also rise but, as is typical, at a much slower rate as the yield curve flattens with short rates rising significantly faster than longer rates. It would not be surprising for the current 300+ basis point spread between one and thirty year prime tax-exempt yields to narrow to 150 basis points or less. C.W. Henderson's active management process tends to perform well on a relative basis in such environments. Duration reductions that lessen interest rate sensitivity, yield pickups from advantageous trading, tax loss harvesting, etc. have served our clients well in the past.

There have been three periods of sharp increases in the Federal Funds rate that occurred during the twenty-three year C.W. Henderson operating history.

Time Period	Federal Funds Move
Feb. 4, 1994 to Feb 1, 1995	3.00% to 6.00%
June 30, 1999 to May 16, 2000	4.75% to 6.50%
June 30, 2003 to June 29, 2006	1.00% to 5.25%

The before fees returns of our two composites during these three periods are shown below. Fees must be deducted from the gross returns to obtain net returns, with 50 basis points being the maximum fee charged.

	Composite Annualized Returns	Index* Annualized Returns	Composite Negative Return Months
Short Composite			
1/31/94 to 1/31/95	3.46%	1.93%	2 of 12
6/30/99 to 5/31/00	3.78	3.37	0 of 11
6/30/04 to 6/30/06	2.50	1.76	1 of 24
Traditional Composite			
1/31/94 to 1/31/95	2.31%	- 1.36%	5 of 12
6/30/99 to 5/31/00	2.47	1.95	6 of 11
6/30/04 to 6/30/06	3.28	2.45	8 of 24

- Benchmarks: Short Term – Barclays 1 Yr. Municipal GO; Traditional – Barclays 5 Yr. Municipal GO

Firm News

We are sorry to relate that Rob Richards who has worked in our Operations/Client Service Group for the past seven years has decided to relocate back to Grand Rapids, MI where he grew up. We thank him for his excellent work and wish Rob the best of luck as he pursues the next stage of his career. Eric Nesi, a recent Notre Dame graduate, will be joining C.W. Henderson this month to take Rob's place. We look forward to having Eric on board.

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