The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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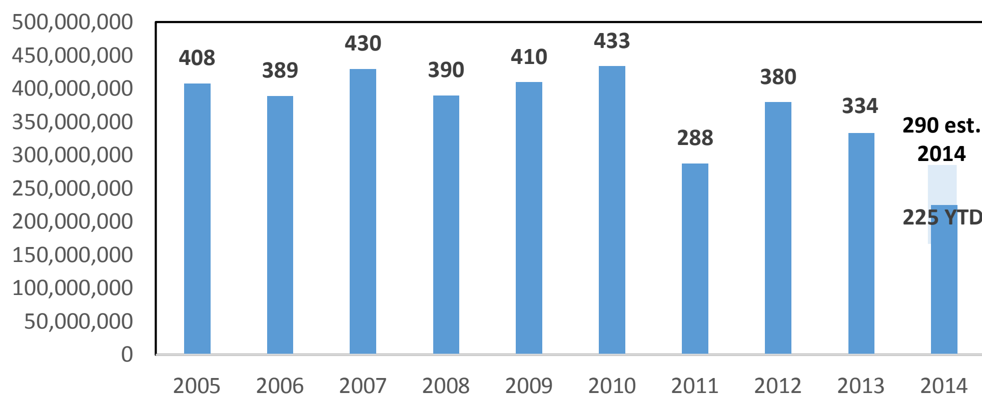
Eyes on the Fed

When will the Federal Reserve Open Market Committee deem the economic recovery to have gained sufficient strength to begin moving the Federal Funds rate back to a "normal" level; i.e. at or above the prevailing inflation rate? Despite a reasonably steady decline in the unemployment rate and gains in non-farm employment, the Fed, as outlined by Chairwoman Yellen, is not ready to begin moving short rates higher. Economic growth remains less healthy than desired in the Fed's view as evidenced by a sub-standard labor participation rate and part time positions accounting for a significant component of recent job creations. Housing construction and consumer spending are trending moderately higher in the U.S., but slowing Chinese growth and a near stall in parts of Europe could have a blowback effect and retard U.S. growth. We take the Fed at their word that short rates will remain low, probably through the first quarter or half of next year.

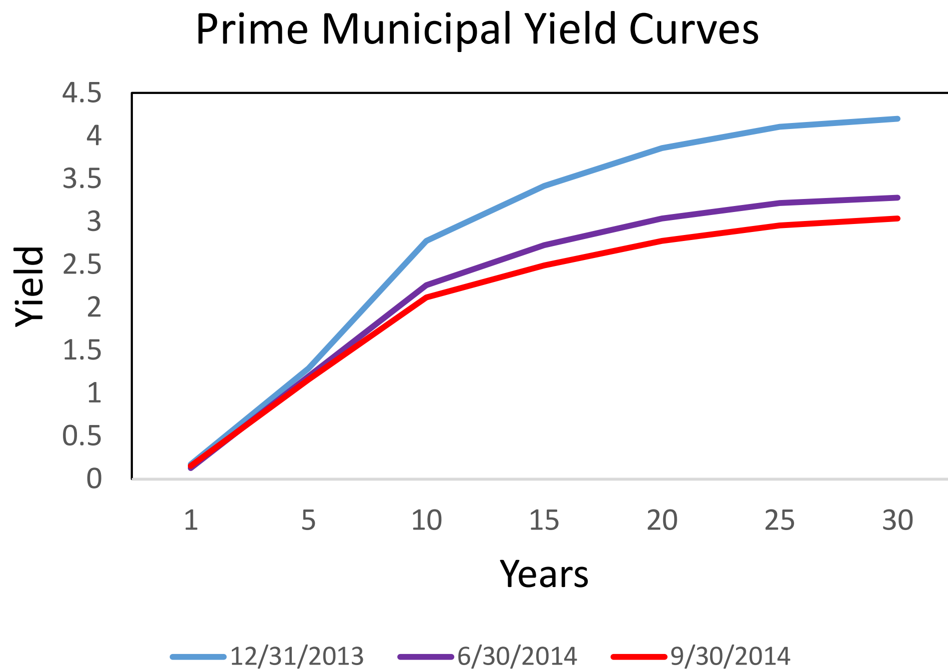
Longer rates are also likely to remain contained over the near term. Investor demand for fixed income securities remains strong in the modest economic growth, low inflation environment. The appetite for U.S. bonds is being augmented by foreign buying. With quantitative easing planned in Europe, rates on the continent are significantly lower than in the U.S. which makes the Treasury market a relative bargain. The situation is similar in Japan where government yields are well below 1%. The strengthening dollar makes U.S. investments even more appealing. Foreign buying has included taxable municipals which are being acquired along with U.S. Treasury securities. We would not be surprised if the ten year Treasury yield remains in a relatively narrow trading range centered well below the 3.00% level for several more months.

The municipal market has been similarly influenced by the economic setting and, in addition, by limited new issue supply. Volume through September totaled approximately $225 billion and is expected to end the year at about $290 billion. This year's projected volume is down significantly from the $376 billion average over the past ten years. Annual issuance is shown in the chart below.



Supply this year has been insufficient to sate the appetite of investors seeking tax advantaged investments. Municipal yields have fallen faster than taxable rates and Treasuries are now out yielding prime tax-exempts throughout the yield curve. The ten year municipal/Treasury yield ratio is currently 87%, down from 96+% a year ago.

The yield curve chart below illustrates the decline in tax-exempt yields this year with long rates having dropped by over a hundred basis points in the face of strong demand.



Need for Continued Vigilance

Despite the outlook for reasonably stable markets in the coming months, it is important to remember that interest rates can move quickly, especially given low prevailing yield levels. We are maintaining shortened portfolio durations and are watchful for signs of stronger than expected growth and/or building inflation that could unnerve the markets. Special focus is on labor costs as they are often a precursor of broader price increases.

In that light it is useful to review the yield surge that occurred in the spring and summer of last year that was precipitated by Chairman Bernanke's comments suggesting that a modest shift in Fed policy was being contemplated. The ten year Treasury yield rose from the 1.66% level at the end of April to over 2% by the end of May and approached 3% in early September. Longer municipal yields rose by 150 basis points or more which produced a dramatic steepening in the yield curve and sharp declines in bond prices. The Barclays ten year, fifteen year and long municipal GO indexes suffered relative declines of 4.22%, 6.07% and 8.09% in the three month period through August of last year.

We do not anticipate a similar reaction when the Fed eventually decides to tighten, but we could be surprised. We expect a cautious approach by the monetary authorities with well telegraphed moves followed by assessments of the impact of each incremental move in the Fed Funds rate. Fewer market makers and lessened capital being allocated to the remaining trading desks has reduced market liquidity which could set the stage for more abrupt yield adjustments and increased volatility.

An eventual rise in the targeted Fed Funds rate of a hundred or more basis points seems likely at some point. Fed tightening will influence longer segments of the yield curve, but probably not to the extent that short rates move, a classic yield curve flattening scenario. To test the impact of a rate rise on the portfolios we manage, we assumed a 150 basis point rise in short rates and a 50 basis point move in ten year yields that takes place over a one year horizon. The before fees total return of the C.W. Henderson composite in this scenario, assuming we took no action, would be a negative 0.50%. That result is highly unlikely. Duration shortening and active trading to take advantage of market aberrations coupled with return enhancements from curve roll down trades and an increased number of bonds with short calls not being called would offset most, if not all, of the static scenario loss. Also, our use of high quality, liquid securities limits price declines associated with widening credit spreads that typically accompany rising rates. Tax loss trading would further enhance tax adjusted returns. As we pointed out in last quarter's newsletter, C.W. Henderson's Traditional and Short-Term products both performed well in past periods of significant Fed tightening.

Municipals and Bank Liquidity

Under new federal rules regarding commercial bank liquidity, municipals will no longer qualify as high quality, liquid assets in the calculation of bank liquidity ratios. The rule is scheduled to become effective January 1st. Banks have been significant buyers of tax-exempt securities in recent years and as of the end of the second quarter they collectively owned close to 12% of the outstanding municipal securities. Households continue to be the major holders of municipals with a 44% share of the market while mutual funds represent about 28% of the total and property and casualty insurers close to 9%. Mutual funds are largely owned by individuals which makes retail investors the dominant factor in the marketplace. Given the liquidity ruling, we expect that bank holdings of municipals will diminish over time as securities mature, but we doubt that sale programs will be initiated. Any bank sales would be easily absorbed in the current low new issue volume environment.

Stockton, California Pension Plan Funding

The judge overseeing Stockton's Chapter 9 bankruptcy proceedings recently ruled that the city has the power to reduce its pension obligations and indicated that a core power under the Bankruptcy Code is the ability to break contracts. This follows a ruling several months ago in the Detroit bankruptcy where the judge determined in that proceeding that pension obligations are not entitled to extraordinary protection, despite state constitutional safeguards. In effect, federal bankruptcy law supersedes state law. Payments into pension funds in California have been considered sacrosanct. As expected, the California Public Employment Retirement system (Calpers) is objecting strongly to the ruling and will appeal.

It remains to be seen what Stockton's next steps will be. Despite the ruling, the city may opt to maintain their Calpers relationship. Separation from Calpers could require the city to pay an estimated $160 million in termination fees and likely force Stockton to establish their own plan with comparable benefits to stem resignations by police, fire and other municipal workers.

Regardless what ultimately transpires in Stockton and Detroit, the rulings are precedent setting and set the stage for other financially stressed municipalities to seek pension plan adjustments. The main takeaway is that pension funding is becoming ever more critical in the assessment of municipal credit quality as is the funding of postemployment medical benefits. These are focal points in our credit review process.

Hedge Funds and Puerto Rico

Downgrades of Puerto Rico debt to non-investment grade precludes many investors with investment grade quality guidelines from investing in the Commonwealth's securities. The subsequent void created by the departure of traditional investors coupled with high potential returns has proven attractive to the hedge fund community. It has been reported that about sixty hedge funds now own 22% of Puerto Rico's general obligation and enterprise debt. Most of the securities were purchased at dollar prices that provide potential for attractive returns. All is dependent on the stabilization of the island's economy and finances. Whether the economy can be reinvigorated, the government work force pared, tax collections increased, outmigration slowed and budget deficits eliminated remains to be seen. If improvements do not materialize in a reasonable time frame, the hedge funds could opt to look for more favorable opportunities elsewhere.

Muni Market Going Green

Funds raised through the sale of "Green Bonds" are dedicated to sustainable and environmentally beneficial projects. The Commonwealth of Massachusetts led the way with a sale last year and followed up with another $350 million sale last month. Funds from the latest sale will partially finance a marine terminal designed to support construction of offshore wind projects and will also be used for clean water, river revitalization, energy efficiency and open space protection projects. The State of California entered the green arena with $200 million of a $2.3 billion September sale designated as green bonds. Other green issues include June sales of $213 million bonds by the New York Environmental Facilities Corporation and $300 million by the D.C. Water and Sewer Authority.

Funds that provide for green bond debt service are not segregated. The same revenue sources that support other enterprise debt also back green bonds. In the case of general obligations, debt service is paid from municipalities' general funds. Green bonds do provide potential benefits to issuers by broadening the market for these securities to socially responsible investors. The current municipal market is not in need of additional demand, but the appeal of green bonds could be beneficial in the future in a less favorable supply/demand environment.

Craig W. Henderson Thomas L. Mallman, CFA

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