The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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Interest Rate Outlook

Among the worst collective forecasts at the beginning of last year was the prediction that longer interest rates would rise in 2014 in response to firming economic conditions and QE tapering. The general expectation was that the ten year Treasury yield would rise by fifty or more basis points from the 3% level that prevailed at the beginning of 2014. In fact, the yield fell to 2.17% at the close of the year and has subsequently declined further to below 2% despite continued moderate U.S. economic growth, the end of quantitative easing and indications that the FOMC is discussing the conditions that would warrant a "normalization" of monetary policy.

Various factors have been at work. First, U.S. economic growth, although positive, has been moderate and inflation has been subdued with year-over-year increases in the CPI well below the Fed's 2% target. The safe harbor role of the Treasury market has been in play as investors have sought refuge in response to the rise of the Islamic State in Syria and Iraq, Russian advances in Crimea and the Ukraine, North Korean sabre rattling, etc. Topping the list is the slowdown in global growth that has been amplified by plunging oil prices. Downward revised Chinese GDP estimates coupled with limited traction thus far from Japanese stimulus and Europe teetering on recession paint a less than dynamic global picture.

International monetary stimulus (coming shortly after the Federal Reserve terminated quantitative easing in the U.S.) has produced a huge disparity between U.S. and foreign yields as shown in the table below comparing Treasury yields with Japanese and German government rates.

	U.S. Treasury	Japanese	German
2 Year	0.65%	- 0.03%	- 0.11%
5 Year	1.50	0.01	0.01
10 Year	1.97	0.28	0.51
30 Year	2.52	1.17	1.30

This rate discrepancy, coupled with the 15+% rise in the exchange rate of the dollar relative to various foreign currencies over the past six months, is continuing to attract considerable foreign investable dollars to the U.S. market. It has been reported that foreign purchases absorbed $284 billion of Treasury debt during the first nine months of last year.

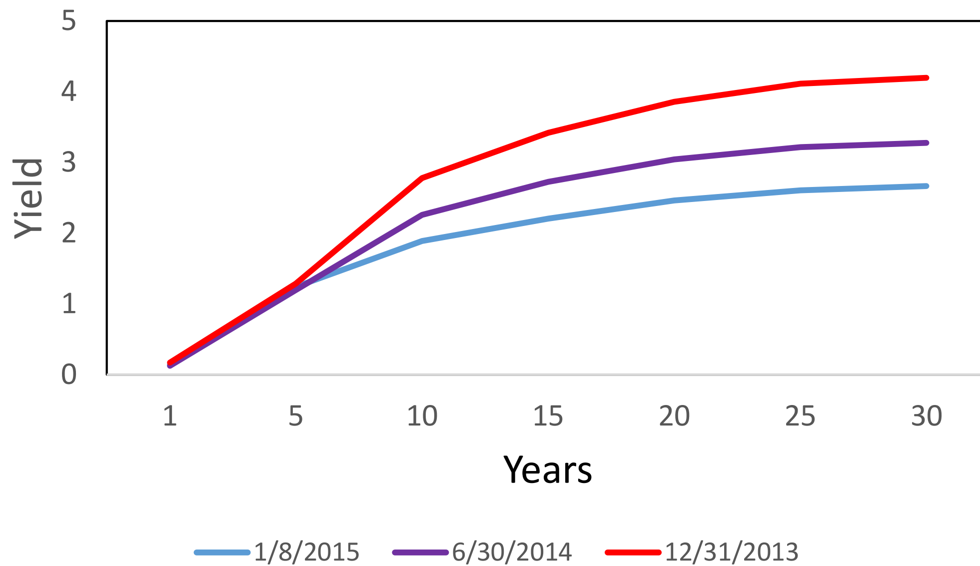
Could U.S. rates move still lower? It is not inconceivable if the global slump continues. It should not be forgotten that the ten year Treasury yield fell to 1.65% in early May of 2013. That is not our forecast, but the possibility of somewhat lower rates cannot be dismissed. Our best guess is that longer rates will trade in a relatively narrow range and remain subdued for several months.

How is the Federal Reserve likely to react? They have advised that they do not anticipate raising rates "for at least the next couple of meetings." Chairwoman Yellen has also stated that the committee

members are "very attentive to global developments." The 50+% fall in the price of oil that is signaling weak world-wide demand qualifies as a significant development and is likely to keep the Fed on hold at least over the near term. Inflation expectations have subsequently fallen in the U.S. and deflation fears are rising in Europe. We expect that the Fed will remain on the sidelines while this picture persists. Should oil prices recover and the U.S. unemployment rate continue to drop, they could adopt a somewhat more aggressive posture and begin moving short rates higher later in the year. Any moves by the Fed are likely to be modest and well telegraphed in advance.

Would a rise in short rates negatively impact longer securities? Probably to some extent, but given domestic and international demand for high quality fixed income securities, we expect that upward pressure on longer rates would be contained. A flattening yield curve would be the most likely development.

Demand for Tax-Exempt Investments Continues
As shown in the chart below, municipal yields followed the Treasury market and also fell sharply last year. Despite the decline, demand for tax advantaged investments persisted throughout the year and was reflected in bond fund inflows and retail buying. Safety and tax avoidance are the drivers of the tax-exempt market's appeal. Although Stockton, California, Detroit and Puerto Rico illustrate the need for continued credit vigilance, investment grade municipal credits continue to be viewed as second only to government securities in providing safety. Security and tax free income are the cornerstones underlying the appeal of the municipal market.



Increased tax rates that became effective in 2013, combined with supplemental charges attributable to the Affordable Health Care Act, pushed personal tax levies sharply higher, further enhancing the appeal of the tax-exempt market. Changes in maximum personal tax rates are shown below:

	Highest Marginal Personal Tax Rates				
	2012 Rate	Current Rate	Health Care Supplement	Total	Increase
Ordinary Income	35%	39.6%	0.9%	40.5%*	16%
Taxable Interest	35	39.6	3.8	43.4	24
Qualified Dividends	15	20.0	3.8	23.8	59
Non-Qual Dividends	35	39.6	3.8	43.4	24
Short Term Gains	35	39.6	3.8	43.4	24
Long Term Gains	15	20.0	3.8	23.8	59
Tax-Exempt Interest	0	0.0	0.0	0.0	0

*Not including 1.45% Medicare Tax

We anticipate that demand for tax-exempt securities will remain strong this year. Taxable equivalent yields are more than competitive with taxable alternatives and, should stock market volatility persist, some investors may opt for increased stability in their overall portfolios. High tax bracket investors have few other alternatives to shelter income.

Despite our generally favorable view of the market, we continue to feel that prudence is appropriate given low nominal rate levels. Rapidly changing conditions could precipitate significant rate volatility. Portfolio durations are targeted at 3.2 years, about 20% below neutral. We are playing defense!

Impact of Rising Rates

While we anticipate a relatively stable market over the near term, interest rates will eventually move higher. How best to position portfolios for that eventuality? Use of high quality securities to minimize the impact of credit spread widening, duration reductions to temper volatility risk and high coupon bonds that cushion the impact of rising rates are obvious basic steps that C.W. Henderson has implemented in client portfolio constructions. The use of barbell structures in traditional product portfolios provides additional defensiveness. Over 60% of assets in traditional product accounts are invested in assets with effective durations of less than a year that have little price sensitivity to rising rates. High coupon bonds with short calls and bullet securities that enhance in value as they roll down the yield curve are the primary strategies utilized in the short component of these portfolios. Remaining assets are invested in high coupon bonds with intermediate calls and ten to twelve year high coupon bonds. Portfolio durations can be quickly adjusted by reducing or adding to the longer components of client portfolios as our interest rate outlook changes. This approach has proven to be extremely effective in controlling portfolio risk. Since the product was started in March of 1991 there have only been nine quarters where pre-fee total return losses were incurred. Tax loss harvesting, which adds significantly to tax-adjusted returns, is not incorporated in our reported results. Many managers with large assets under management find it difficult if not impossible to engage in tax loss trading programs.

Our Short Term product is significantly more defensive. These portfolios are constructed utilizing only the strategies that comprise the short component of the barbell structured traditional accounts – high coupon bonds with short calls and short bonds that roll down the yield curve. Portfolio durations are typically about 0.80 years which significantly limits sensitivity to interest rate moves. In addition, high coupon callable bonds typically experience fewer calls as rates rise producing positive convexity in these securities. There have only been two negative pre-fee quarters since the inception of this product in September 1991, with the largest at -0.11%. Also, this product performed extremely well during periods of Federal Reserve tightening as shown below:

Time Period	Annualized Fed Funds Move	Composite Return*
1/31/94 to 1/31/95	3.00% to 6.00%	3.46%
6/30/99 to 5/31/00	4.75% to 6.50%	3.78%
6/30/04 to 6/30/06	1.00% to 5.25%	2.50%

*Pre-fee returns. Returns reduced by 50 BP for accounts paying maximum fees.

Fourth Quarter Supply Unexpectedly Strong

According to The Bond Buyer's initial tally, new issuance surged in the fourth quarter which brought the total for the year to approximately $334 billion, in line with 2013 but about $50 billion less than the average new issue volume over the past ten years. Initial forecasts for 2015 suggest that volume will approximate last year's issuance, but at this point estimates are not terribly meaningful. Healthier tax collections and improved operating fund balances could prompt municipalities to focus on delayed infrastructure enhancements which might bolster new financings to some extent. A surge in volume does not appear to be in the cards.

Pension Obligations Take Priority in Bankruptcy

Both Stockton, California and Detroit emerged from bankruptcy during the quarter. In each instance pension obligations were totally or largely maintained while bond holders suffered losses. Stockton upheld its obligation to CalPers while Franklin Funds received minimal payment on its $35 million holding of the City's bonds. Cuts to Detroit pensions were limited to 4.5% while haircuts to general obligation bonds approximated 26% with bond insurance absorbing the loss. In both instances pensions were treated as senior to bonded debt which establishes precedent in these states. The need to include pension and OPEB funding in credit reviews is obviously a crucial component of a thorough analysis process.

Firm News

Declining rates produced excellent absolute and relative returns for our clients in 2014. C.W. Henderson had $2.72 billion in assets under management at the close of the year. We are extremely appreciative of the confidence of our clients and professional counterparts in the financial community. We wish you all a healthy and prosperous 2015.

Craig W. Henderson Thomas L. Mallman, CFA

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