The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing
in Tax-Exempt Municipal Securities

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The Fed Delays Again

Despite the rebound in U.S. economic activity in the second quarter and a decline in the U.S. unemployment rate to 5.1%, the Federal Reserve opted for another delay in moving the Federal Funds rate at the September FOMC meeting. The strong dollar that is restricting U.S. exports and sluggish global growth influenced the Fed's decision. A falling Chinese growth rate combined with lackluster European economic activity and a slowdown in many emerging countries due to the drop in demand for commodities is impacting worldwide economic activity. The targeted federal funds rate remains near zero, where it has been since December 2008. The FOMC members are probably pleased that they opted not to move given the October 2nd report of a weaker than expected 142,000 increase in non-farm employment in September along with revisions to the July and August employment reports that lowered hiring in those months by 59,000.

A less than 2% desired domestic inflation rate is also an issue for the Fed. The core CPI is currently advancing at about a 1.80% annual rate and the Personal Consumption Expenditure Index at roughly 1.40%. Weak energy prices, limited wage growth and dollar strength are curtailing price pressures. A few commentators have suggested that the 5.1% unemployment rate could be approaching the NAIRU (non-accelerating inflation rate of unemployment) limit and further declines will precipitate price pressure. Sluggish wage growth, high levels of part time employment and the low labor force participation rate argue that this concern is currently unwarranted.

Despite the Fed's delay last month, Chairwoman Yellen asserted in a recent speech that the Fed plans to move before year-end. There are two remaining FOMC meetings this year, October 27 and 28 and December 15 and 16. Recent speculation has focused on the Fed moving at the December meeting, but late year timing could be complicated by Congressional politics. Speaker Boehner's decision to resign from Congress at the end of October provided flexibility to enact a stopgap funding bill that finances the government through December 11 and circumvented a possible government shutdown over Planned Parenthood funding. What Congress does in December remains to be seen, but from the Fed's perspective moving rates at the same time a budgetary battle is being waged would not represent opportune timing.

With monetary policy on hold, interest rates have traded in a relatively narrow band. The ten year Treasury yield remained in the 2.00% to 2.25% range during most of the quarter, but momentarily dipped to just under 2.00% at the start of October in response to the weak September labor report.

Tax-exempt yields also traded in a narrow range during the past quarter and followed the Treasury market's lead. As shown in the table below, the ten year prime municipal yield started the period at 2.36% in early July but trended lower throughout the quarter. We anticipate that municipal rates will also remain in a narrow range near term. Absent some shock, we do not expect that yields will decline significantly from current levels. Investor demand tends to wane when ten year AAA municipal yields fall below 2.00%.

Prime Municipal Yields

	1/30/15	3/30/15	7/01/15	10/05/15
1 Year	0.15%	0.23%	0.30%	0.23%
5 Years	0.95	1.21	1.44	1.33
10 Years	1.74	1.99	2.36	2.01
15 Years	2.13	2.44	2.82	2.51
20 Years	2.34	2.36	3.06	2.79
30 Years	2.49	2.89	3.31	3.05

Municipal Supply/Demand

As we pointed out in previous newsletters, a heavy flow of refunding issues produced a surge in tax-exempt supply during the winter and early spring months of the year and issuance totaled $217 billion during the first half. New issue volume fell to under $100 billion in the past quarter and appears to be on track to total about $410 billion for the year. Assuming rates do not decline significantly, we anticipate that demand for tax-exempt income will allow the new issue flow to be absorbed with little difficulty.

A recent study indicated that households remain the largest holders of municipals and owned over 42% of outstanding securities as of the second quarter of this year. Mutual funds, which are largely held by individual investors, accounted for about 18.5% of the market while money market funds held 7% of outstanding assets. Banks, casualty and life insurance companies and other corporations hold much of the remainder. Interestingly, foreign buyers have also been buying municipals. According to a Federal Reserve report, non-U.S. investors owned $85.7 billion tax-exempt bonds in the second quarter which represented 2.3% of the $3.72 billion market. Given low interest rates in Europe and Japan (e.g. ten year German and Japanese government bonds are yielding, respectively, 0.50% and 0.35%) municipals offer very competitive returns.

Mutual funds experienced weekly outflows during much of the quarter following the trend seen earlier in the year. Investor concern regarding Puerto Rico holdings in many funds, which, in some instances are quite significant, is prompting movement. Potential volatility risk is also of concern for many funds that utilize large components of long duration bonds in their attempt to maximize fund yields. These concerns are reflected in closed end municipal fund pricing. Closed end funds typically trade at moderate 7% to 8% discounts from their net asset values. Some discounts now exceed 15%.

Portfolio Strategy

At some point the Federal Reserve will begin to raise interest rates. If Ms. Yellen’s latest projection proves correct, a move will be made in October or December. She has also indicated that the pace of subsequent rate increases will be dependent on the board’s assessment of economic and market conditions. The bias will be to be towards higher rates but moves by the Fed are likely to be infrequent over the next year assuming the economy continues to grow at a modest pace and

inflation remains subdued. Higher short rates may cause longer yields to be nudged a bit higher, but we doubt that the impact along the curve will be significant. A flatter yield curve is most likely. This is especially true in the municipal market that is trading at attractive levels relative to Treasuries. Longer maturity municipal yields are at or above Treasury levels.

C.W. Henderson's best relative returns tend to be realized in environments where rates rise moderately and the yield curve flattens. The bonds we utilize in the short components of the barbell structures we employ have limited price risk due to their short effective durations. Turnover in this portfolio segment allows us to take advantage of rising rates as proceeds from sales of short maturity bonds are reemployed at higher yields. Higher short rates also tend to reduce the number of high coupon bonds with short calls that are called prior to maturity. Getting past calls produces significant yield enhancements. Recently a 5% coupon bond with a ten month call and a late 2017 maturity was purchased at a 0.30% yield to call. The bonds will return in excess of 2.00% if they remain outstanding until maturity. For comparison, non-callable two year prime bonds are currently yielding about 0.60%.

We are targeting portfolio durations at about 3.60 years, about 12% below neutral. While we do not expect longer rates to move dramatically higher over the near term, we feel it prudent to limit volatility risk in the current low nominal rate environment.

Puerto Rico Developments

As we have discussed in previous newsletters, Puerto Rico does not have sufficient resources to service the $72 billion of general obligation and enterprise debt outstanding. Negative Real GNP growth in every year but one since fiscal 2007 coupled with outmigration that averaged 48,000 annually from 2010 to 2013, and may be accelerating, has reduced the commonwealth's productive workforce. Persons sixty years and older now represent more than 20% of the population.

Governor Padilla established a Working Group to develop a Fiscal and Economic Recovery of Puerto Rico Plan. The Working Group's recommendations includes economic development, structural reforms and debt restructuring designed to meaningfully reduce the Commonwealth's projected financing gap. The five year short fall is projected to total $27.8 billion from fiscal year 2016 through fiscal 2020 absent any corrective action.

The Working Group believes that the Commonwealth could reduce its cumulative financing gap by close to $13 billion over the FY 2016 to FY 2020 period if its recommendations are implemented. A financial control board consisting of five members appointed by the governor is tasked to oversee the process. Even if the recommendations are implemented (by no means certain given anticipated political and legal challenges), the cumulative five year funding gap is estimated to total $14 billion. Restructuring existing debt needs to be part of the solution and Puerto Rican authorities are continuing their efforts to persuade the U.S. government to provide a legal framework for the orderly restructuring of the Commonwealth's liabilities (i.e. Chapter 9 bankruptcy authorization of some variant).
A restructuring agreement was recently negotiated between the Puerto Rico Power Authority and bond holders that included mutual fund groups and hedge funds. The settlement is forecast to reduce the power authority's principal and interest expense by over $700 million over the next five

years. Bondholders are slated to receive 85% of the face value of their existing bonds in exchange for new securities that will be designed to warrant investment grade ratings. This agreement is likely to be followed by additional negotiated debt restructurings.

As we have pointed out before, C.W. Henderson has never purchased any Puerto Rican securities and has always liquidated commonwealth bonds inherited with new accounts.

Public Pension Funding

Analysis of pension plan funding has become an increasingly critical component of municipal credit analysis. Required pension contributions have grown in conjunction with expanded benefits and increased retiree longevity causing some plans to be significantly underfunded - in some instances at 50% or less. Fortunately, economic growth over the past few years has produced increased tax revenues for state and local municipalities and provided flexibility to increase plan contributions. It has been reported that, on average, municipal pension plans across the U.S. were 72+% funded earlier this year. However, these calculations were made before the onset of the stock market decline. Average funding ratios have most certainly slipped to some degree. C.W. Henderson generally views 70% plan funding as a minimum for credit acceptance.

Some plans have been restructured to reduce annual required contributions. Reduced benefits, higher employee contributions, shifts to 401K type plans, etc. have been incorporated in revised plans. In some cases this is not an option. Chicago provides a current example. The Illinois State Supreme Court ruled that benefits promised in the Police and Firefighter plans cannot be reduced. Past underfunding of these plans prompted Mayor Emanuel to propose a $543 million property tax increase along with higher service fees to fund a $7.8 billion 2016 budget that includes a $328 million contributions to the City's fire and police plans. Additional tax increases, user fees and/or service reductions appear likely after the Illinois Supreme Court rules on the constitutionality of proposed reforms to the City's Municipal and Laborers pension plans.

Firm News

We are pleased to announce that Andrew Castellucci has joined the credit research group and is working with Dan Thorpe to analyze new offerings and monitor existing holdings in client portfolios. Credit research is a core component of the C.W. Henderson risk control process.

Given recent equity market volatility we ask that you inform us if tax losses have been realized. This information improves our ability to efficiently manage your account and take advantage of attractive trades that might otherwise not be considered. Thank you for your help.

Craig W. Henderson Thomas L. Mallman, CFA

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