The Investor's Edge

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C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING
IN TAX-EXEMPT MUNICIPAL SECURITIES

Background and Outlook

After seven years of aggressive monetary stimulus with near zero short term interest rates and successive rounds of quantitative easing, the Federal Reserve took a well forecast baby step in December and notched the Federal Funds rate higher by a quarter of one percent. The new targeted range is 25 to 50 basis points. Fed Chair Yellen has indicated that additional increases are likely this year but dependent on the pace of economic activity and an increase in core inflation to near the Fed's desired 2% desired pace.

The FOMC's current projection is for four additional increases this year, but that seems aggressive given the fragility of the world economy with limited, if any, growth in Europe and declining growth in China. With deflation a concern in parts of the world it is questionable whether U.S. inflation will move meaningfully higher given sagging energy prices and limited wage growth. Our working assumption is that U.S. growth will remain positive but subdued with RGDP tracking at a 2+% rate spurred by some strengthening in consumer demand but also negatively impacted to some degree by a sluggish manufacturing sector and curtailed exports due to dollar strength.

This suggests an environment where some modest additional pressure is likely to develop on the short end of the yield curve in response to one or two Fed moves, but it is questionable as to how much impact there will be on longer rates if growth remains modest and inflation subdued.

The table below illustrates prime municipal yield curve rates at the beginning of last year as well as the highs and lows during the year and current levels. The decline in longer rates since late May, which accelerated in recent days, reflects growing uncertainty over the global economy, equity market volatility and to some extent a flight to safe harbor securities in reaction to heightened global terrorism. The sharp decline in the Chinese equity market at the beginning of this month is reflective of global market fragility. The uptick in the one year yield in response to Fed tightening is also evident in the table below.

Prime Municipal Yields

	Current	5/20/15	1/28/15	12/31/14
1 Yr.	0.51%	0.27%	0.15%	0.17%
5 Yrs.	1.11	1.51	0.96	1.31
10 Yrs.	1.77	2.36	1.77	2.05
15 Yrs.	2.20	2.85	2.16	2.36
20 Yrs.	2.45	3.10	2.38	2.60
30 Yrs.	2.70	3.30	2.53	2.88

Despite our expectation that longer rates will remain reasonably subdued over the near term, we are maintaining lower than neutral portfolio durations in client accounts. Increased potential volatility associated with low rates argues for a degree of caution. Our caution is also influenced by market liquidity concerns. The municipal dealer community is shrinking with a reported 13% decline in the number of firms since 2011. Broker/dealer inventory levels have also been pared significantly as firms' risk appetites have declined in response to heightened regulatory restrictions. Broker/dealer municipal inventories currently total about $19 billion, down from $31 billion in early 2013.

Price volatility is typically contained when the markets are stable and/or rates are declining, but likely to be amplified during market downturns when limited bids are available to absorb liquidated securities. Should we encounter a spurt in rates similar to what occurred in mid-2013 (the ten year prime municipal yield rose from 1.68% in early May of that year to over 2.90% in late June) we would expect significant volatility and sharply widening bid/ask spreads.

Another reason for conservatism is the richness of the municipal sector relative to Treasuries. Investors scrambling for tax-exempt income in an environment of limited supply in the opening days of the new year have pushed municipal/Treasury yield ratios to extreme lows. For example, the seven year municipal market data/U.S. Treasury (MMD/UST) ratio is under 70%, the lowest level since the seven year Treasury was first auctioned in February 2009. The previous low was 72.8% while the widest spread, 132.7%, occurred in March 2009.

Impact of Rising Short Rates on Portfolio Performance

We have commented in past newsletters about C.W. Henderson's performance in rising rate environments. In general, the barbell portfolio structures we utilize tend to deliver strong relative returns during periods of moderately rising rates and flattening yield curves. The short components of the barbell structures (typically over 50% of total portfolio assets) have limited effective durations of six to eight months and are only modestly impacted by rising short rates. High coupon bonds with short calls that comprise a significant portion of the short portfolio component tend to perform well as rates rise due to a reduction in the number of bonds that are called. For review, consider a 5.0% coupon bond with a four year maturity that is callable in six months at par. Securities of this type can be purchased at about a 0.30% yield to call that equates to a dollar price of approximately 102.35. At the call date the dollar price will have declined to par resulting in a principal loss of 2.35% which is offset by half of the annual coupon, 2.50%, for a net return of 0.15%, 0.30% on an annualized basis. If the bond is not called, the owner receives a 2.50% return during the next six months and a total return for the year of 2.65%. As subsequent calls are passed the return continues to increase until maturity. These are very defensive securities with potential to significantly outperform other shorter term instruments. They are also positively convex since the incidence of calls declines as rates rise.

Longer portfolio holdings (ten to fifteen year maturity bonds with long calls) that comprise the extended component of the barbell structures may experience some price pressure if longer rates rise, but by limiting portfolio exposure to this sector we control overall portfolio durations and interest rate sensitivity.

As short rates rise the attractiveness of the C.W. Henderson short term product increases significantly. This product has an effective duration of six to eight months and portfolios are constructed with the same types of securities that comprise the short component of the Traditional Product barbell structure – high coupon bonds with short calls described above and fifteen to eighteen month securities that increase in value as they roll down the typically steep short portion of the yield curve. This product is designed to provide value relative to municipal money market funds and to taxable money market alternatives.

The attractiveness of the Short Term product is enhanced by recent changes to SEC Rule 2a-7 that apply to the management of non-Treasury money market funds. Institutional money market funds (those with investors who are not "natural persons") will have mark-to-market net asset values calculated to four decimal places, up or down from 1.0000. More importantly, these funds will be subject to gates and fees. If weekly liquidity falls to less than 30% of fund assets, the fund's trustees can suspend redemptions (impose gates) and/or impose charges of up to 2.0% on withdrawals. If daily liquidity falls to less than 10% of fund assets, a charge of 1.0% must be imposed unless deemed inappropriate by the fund's trustees.

Will gates and fees ever be imposed? Hard to say, but given the periodic incidence of money market funds coming close to or actually "breaking the buck" over the years, the risk is not immaterial. The appeal of separate accounts held in clients' names with unencumbered liquidity is likely to have significant appeal after the 2a-7 rule changes are implemented.

Supply/Demand

A slowdown in new issuance in the last six weeks of 2015 caused new issue volume to be pared from earlier estimates and total an estimated $395 billion for the year. Strong demand for tax-exempt income easily absorbed this supply. Estimates for issuance this year range widely from a low of about $350 billion to well over $400 billion. New money financings are expected to total about $175 billion with refunding issues representing the bulk of the remainder. New money financings have been slowly increasing in the past few years and totaled $165+ billion last year, an increase from the $140 to $150 billion that prevailed for several years. Continued growth in the number of issues is anticipated as an improving economy enhances municipalities' tax receipts and operating flexibility. Many infrastructure projects have been delayed since the recession as municipal officials have been hesitant to present new projects requiring tax increases to voters. This hesitancy appears to be diminishing to some degree. Whatever the 2016 new issue volume totals, we anticipate little difficulty in it being absorbed.

Puerto Rico Defaults

The commonwealth paid approximately $330 million January 1st to meet general obligation debt service obligations that are constitutionally guaranteed and $383 million to service highway and convention center debt. However it missed $37 million payments on Infrastructure Financing Authority and Public Finance Corporation bonds.

The default is the latest chapter in the Puerto Rico's financial struggle as it attempts to manage a $70+ billion debt load in an environment of continued negative growth, high unemployment, limited tax receipts and population flight. Additional lapses in debt service payments appear likely

as officials seek to balance the need to provide services to the island's citizens with meeting bond holder claims. Strong efforts are being made to service general obligation and government guaranteed debt, but at the expense of less well secured obligations.

Puerto Rico has appealed to Congress for authority to enter into Chapter 9 bankruptcy proceedings. The Senate Judiciary Committee, which has jurisdiction over bankruptcy laws, has been hesitant to take action. Lack of an absolutely clear picture of the commonwealth's finances is part of the issue as audited FY 2014 financials are significantly overdue and unavailable. Also a concern is the precedent setting nature of this step which could, at some point, open a door for states encountering financial distress to seek bankruptcy protection. No congressional action is anticipated any time soon. Additional missed payments and/or negotiated settlements, as in the case of the Puerto Rico Electric Power Authority, are likely to be the primary avenues the commonwealth utilizes moving forward.

Public Pension Fund Investment Returns

Much has been written about the "new normal" investment returns that are likely in an environment of limited equity gains and paltry fixed income yields. As an example, it was reported that the California Public Employees Retirement Fund earned 2.40% for the twelve months ended last June. When returns fall below targeted levels (7.0% and 7.5% expected returns are typical), actuarially required contributions increase. This could be a growing issue if investment returns remain low over the next few years and represents an additional credit risk that must be monitored. Assessment of defined benefit plan funding levels as well as postemployment health care funding remains an essential component of the credit analysis conducted by C.W. Henderson.

Firm News

We are pleased to introduce Steve Wool who joined C.W. Henderson in November as Vice President of Business Development. Steve has extensive experience in the municipal market in portfolio management, trading and sales most recently at Eaton Vance in New York. His resume also includes other past affiliations such as Legg Mason and Kidder Peabody. We are excited to have Steve on board.

At the close of last year C.W. Henderson managed $2.8 billion of client assets in 1,081 accounts. We remain extremely grateful for the confidence of our clients and the assistance of numerous partners who aid our effort as we work to provide high quality municipal bond portfolio management.

We wish all a healthy and prosperous 2016.

Craig W. Henderson   Thomas L. Mallman, CFA   Matt Andrews

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