The Investor's Edge

June 30, 2016

C.W. HENDERSON & ASSOCIATES, INC.

INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

Flight to Safety

Minutes from the Federal Open Market Committee's April 26, 27 meeting indicated that the Fed was on track to raise the targeted Federal Funds Rate by another notch from the 0.25% to 0.50% range established last December. However, the assumption of continuing employment gains was jolted by the meager 38,000 increase in May non-farm payrolls along with reductions in the reported employment gains in March and April. That put the Fed on hold at the mid-June FOMC meeting as did the pending month-end Brexit vote. The vote, unexpectedly in favor of Britain leaving the EU, sent equity markets in an initial tail spin and prompted investors to once again opt for the safety of the high grade fixed income markets. The ten year benchmark Treasury yield fell to a record 1.37%, dropping below the previous 1.43% low set in July 2012 and dramatically below the 2015 year end 2.27% level. The subsequent report of a recovery in June employment (+287,000; unemployment rate 4.9%) suggested that moderate domestic growth is continuing which stabilized the markets. The following chart depicts daily closing yields for the ten year Treasury through early July.

As shown in the following table, ten year prime municipal yields trended lower while trading in a narrow band during the first five months of this year. Following the Treasury market's lead, tax-exempt yields declined sharply in late June with the ten year prime municipal yield closing the quarter at 1.35%, down from the 1.94% year end level.

Prime Tax Exempt Yields

	07/12/16	05/31/16	3/31/16	12/31/15
1 yr.	0.52%	0.61%	0.55%	0.51%
5 yrs.	0.86	1.12	1.09	1.26
10 yrs.	1.33	1.68	1.70	1.94
15 yrs.	1.61	2.01	2.14	2.28
20 yrs.	1.84	2.27	2.44	2.54
30 yrs.	1.96	2.44	2.67	2.81

Yield declines produced surprisingly strong total returns in the fixed income markets in the first half of the year. As reported in "Barron's", the ten year Treasury returned 7.97% compared to 3.84%, including income, for the S&P 500. For comparison, a strong AA rated thirteen year maturity municipal with a 5.0% coupon and a ten year call at par (the type of security utilized in the long end of the barbell structured portfolios that C.W. Henderson manages), would have been priced to yield about 2.50% to the call at year end and now trades at 1.76% yield to call. Respective dollar prices of 122.00 and 129.59 represent a 6.22% price gain.

Are further yield declines in store? Unsettled global markets, moderate domestic growth and limited inflation pressure are likely to contain yields over the near term. On the inflation front median hourly wages are up 2.60% over the past twelve months. However, with commodity prices languishing there is insufficient price pressure to move the inflation rate to the Fed's desired 2.0% level. Low Treasury yields and negative TIP rates suggest that the market's current expectation is for price increases of perhaps 1.50% annually over the next several years. Given the combination of low inflation, a politically unsettled Europe and meager global growth along with demographic headwinds and limited productivity gains in the U.S., it now appears likely that the Fed will remain on hold for an extended period of time.

Will longer rates also remain low? Upward pressure on interest rates is likely to be limited near term although a moderate uptick in yields is possible as the Brexit dust settles. Strong domestic demand for tax advantaged investments should contain rate pressure in the municipal sector despite a forecast of increased supply in the second half of the year as refunding issuance increases. Demand for tax-exempt income is evidenced by heavy mutual fund purchases with tax-exempt funds having experienced 39 consecutive weeks of inflows. The need to reinvest coupon income in the coming months should continue to bolster municipal mutual fund demand as well as direct purchases of municipal securities.

Despite our expectation of limited near term rate pressure, we continue to target portfolio durations below neutral at 3.40 years. Low nominal yields, nonexistent real returns in shorter maturities and the potential for increased volatility all argue for caution in the current environment.

Negative Interest Rates

Since the 2008/09 recession central banks have opted for extreme monetary accommodation to spur economic growth. Interest rate cuts that brought short rates to near zero, and real short rates below zero, were followed by quantitative easing moves. Europe and Japan have taken additional steps with negative nominal interest rates in their efforts to counteract disinflationary pressures and stimulate

commercial bank lending and consumer demand. The table below compares yields on government securities in the U.S. with those in Germany, Japan and the U.K.

Government Debt Interest Rates

	U.S.	Germany	Japan	U.K.
2 yrs.	0.66%	- 0.68%	- 0.36%	0.16%
5 yrs.	1.03	- 0.58	- 0.37	0.39
10 yrs.	1.43	- 0.10	- 0.29	0.80

Differentials between U.S. and foreign rate levels, coupled with the dollar's strength, are expected to continue to drive foreign demand for U.S. fixed income securities as global investors search for yield. Huge volumes of U.S. government and municipal bonds are being acquired by foreigners in their quest for yield, quality and portfolio diversification. We anticipate that foreign demand will continue for the foreseeable future which will also act to restrain rate pressures and possibly drive yields still lower.

Are negative rates possible in the U.S.? Fed Chair Janet Yellen has not ruled them out should economic conditions deteriorate severely, but in our view the likelihood is extremely low. As noted above, domestic growth, while muted, continues to be positive with employment gains back on track and consumer spending showing signs of improvement.

Municipal Investments in Low Rate Environments

Portfolio allocations to fixed income almost always have merit for investors in need of income and/or seeking to offset potential market volatility in other sectors of their portfolios. This remains true even in the current low rate environment, especially with a growing retiree cohort in the U.S. searching for income and greater stability in their portfolios.

We doubt that significant upward rate pressure will be experienced in the foreseeable future. However, should taxable rates rise we would anticipate slower increases in municipal rates as strong demand for tax-exempt income moderates the extent of a yield rise in the municipal sector. Ten year prime municipals are currently yielding 90+% of like maturity Treasuries, a reflection of the slower movement in municipal yields to the downside during the recent rally. A decline in the municipal/Treasury yield ratio to 85% or lower would not be surprising as investors are attracted by higher rates.

Intermediate Product portfolios managed by C.W. Henderson currently have about 35% of account assets invested in longer duration securities. Remaining portfolio assets are primarily invested in intermediate high coupon securities with short calls and fifteen to eighteen month bonds that increase in value as they roll down the yield curve. These securities experience very limited volatility as interest rates rise. The negative effect of a rate rise on an entire portfolio would therefore be limited. Offsetting a yield rise impact would be the opportunity to reinvest cash flows at higher yields as would tax loss trading that can lock in short term losses with 40+% tax offsets.

Puerto Rico Defaults

As expected, a $2 billion Puerto Rico debt service payment due on July 1st was not paid. Puerto Rico's government approved a debt moratorium this spring in acknowledgement that the commonwealth is

unable to service its $70+ billion of outstanding debt. With cash on hand at "dangerously low" levels, they opted not to make any of the $779 million payment due on general obligation bonds as well as the July 1st debt service on various authority obligations.

The immediate market impact was muted given that the commonwealth's default was highly anticipated and priced in Puerto Rican securities. Occurring at a time the bond market was experiencing a strong rally further tempered the impact. The longer term reaction as additional defaults occur remains to be seen, especially in funds with large Puerto Rico exposures and in state specific funds where Puerto Rico bonds were included to provide federal and state tax exempt income. (Income from U.S. territory debt is exempt from both federal and state taxation.) Many investors in state specific funds may be unaware that Puerto Rico debt is included in their fund portfolio holdings. If net asset values in these funds are significantly impacted there could be a strong negative investor reaction. More broadly, default of this massive debt issuer will likely impact investor psychology in some manner. Puerto Rico's default again emphasizes the necessity for high credit standards and the need for thorough analysis to understand credit risk. Credit research has never been more important!

The good news in regard to Puerto Rico is that bi-partisan legislation creating a seven person control board to oversee the island's finances was signed by President Obama in late June. Appointments to the Board are to be made by December 1st. The board will be empowered to conduct audits, subpoena documents, override spending plans and impose reforms to pensions, taxes and government worker pay. Creditors and the commonwealth's eighteen debt issuers will be provided space to negotiate settlements. If negotiations fail, a supermajority of the control board could authorize a federal court restructuring. Pension plan funding will also fall under the oversight of the control board. The board is to remain in effect until Puerto Rico's government has recovered access to capital market funding and produced four years of balanced budgets. We anticipate that the control board will operate for an extended period of time.

Lack of Illinois Budget Impacts In-State Universities

Despite a $1 billion allocation to higher education approved by Springfield late last month, Moody's slashed the ratings of six public universities in Illinois. Moody's indicated that the state's stopgap budget came too late to curtail concerns regarding the uncertainty of state aid and the liquidity of these institutions. A total of ten credits from Eastern, Northern, Northeastern and Southern Illinois Universities were all impacted along with Illinois State University and Governor's State University. Five credits from these institutions remain investment grades with Baa1, 2 and 3 ratings, three have Ba1 or 2 ratings, one credit carries a B1 rating and one is rated Caa1.

Sensing potential liquidity problems in regard to Illinois university debt, C.W. Henderson disposed of small holdings of Southern Illinois University securities (Baa2/BBB+) over five years ago while they carried A level ratings. We remain cautious regarding all State of Illinois related credits. The State currently carries ratings of Baa2 and BBB+, respectively, from Moody's and S&P, the lowest in the nation.

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

This newsletter may contain material received from outside sources that we consider reliable. However, no representation is made to its completeness or accuracy. C.W. Henderson & Associates, Inc. All rights reserved.