The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Securities

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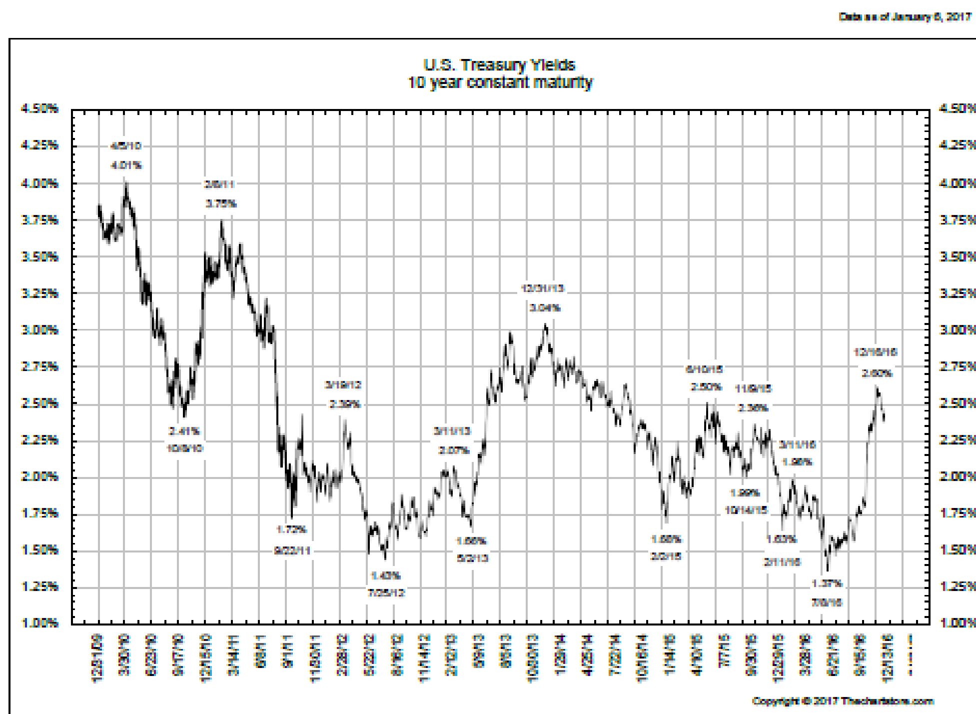
Interest Rates Move Higher

Yields declined during the first half of 2016 in response to sluggish domestic growth in the first quarter, tepid global growth and uncertainty over Brexit and its impact on the European Union, Middle East unrest, terrorist attacks in Europe and ambiguity regarding the pending U.S. election. As depicted in the attached chart of ten year Treasury yields, rates bottomed about midyear and then began a moderate reversal. The move to higher levels accelerated after President elect Trump's victory in November. The perceived prospect of a lessened regulatory environment, lower taxes and a pro-growth agenda developing under Republican leadership stimulated an equity market rally and a sharp rise in interest rates. The ten year Treasury yield closed the year at 2.45%, up from a 1.37% low in mid-July.



Despite uncertainty regarding the Trump administration's impact on the upcoming economic landscape, continued employment growth and a 4.6% unemployment rate emboldened the Fed and prompted a 25 basis point increase in the targeted Federal Funds rate at the December FOMC meeting. Combined with a prior 25 basis point move a year earlier in December 2015, the targeted Fed Funds range is now 0.50% – 0.75%, up modestly from the near zero level that prevailed for seven years from late 2008 to 2015.

Municipal yields followed a similar pattern during the year with tax-exempt rates bottoming about midyear, rising modestly in the next few months, and then moving sharply higher after the election. As shown in the following table, intermediate and longer yields peaked in early December before declining modestly.

Prime Tax Exempt Yields

	1/10/17	12/1/16	10/31/16	9/30/16	6/30/16	12/31/1
1 Yr.	1.00%	0.97%	0.71%	0.79%	0.55%	0.51%
5 Yrs.	1.68	1.95	1.14	1.02	0.91	1.26
10 Yrs.	2.23	2.60	1.74	1.51	1.35	1.94
15 Yrs.	2.61	2.93	2.16	1.90	1.66	2.28
20 Yrs.	2.85	3.20	2.41	2.15	1.90	2.54
30 Yrs.	2.98	3.37	2.56	2.30	2.02	2.81

The impact of the Fed's tightening is reflected in the rise in short rates in the fourth quarter and the recent flattening of the yield curve. The early December 240 basis point spread between one and thirty year prime tax-exempt yields (3.37 – 0.97) has subsequently narrowed to 198 basis points as short rates have ticked higher while longer rates declined.

Interest rates in 2017?

The year begins with the prospect of Mr. Trump's aggressive agenda combined with a Republican controlled Congress eager to implement changes. We anticipate that governmental action early in the year will focus on reform/repeal of the Affordable Care Act, a Supreme Court justice nomination to replace Antonin Scalia, regulation reduction, immigration control and trade negotiations. Tax reform is anticipated to become a priority a bit later in the year with legislation clearing Congress in the fall.

Despite a flurry of legislative activity, the impact on the economy in 2017 is likely to be limited. We anticipate that two plus percent RGDP growth will continue for the most of the year and possibly longer. Labor costs are advancing in the low unemployment rate environment (plus 2.9% in 2016) and we anticipate additional modest increases. Energy costs should be reasonably contained, but inflation rates could drift somewhat higher. However, a sharp rise in the CPI appears unlikely in an environment of moderate global growth. Market volatility is likely to be with us and possibly some slight upward pressure on longer interest rates, but we doubt that the yield on the ten year Treasury will exceed 3.0% on a sustained basis over the course of the year.

The short end of the yield curve will, as always, be impacted by Federal Reserve policy. Fed Chair Yellen has suggested that additional rate increases are on the table with as many as three moves over the course of this year. We anticipate that perhaps two tightening moves will take place. Federal Reserve action could pressure longer yields to some extent, but the primary impact of Fed tightening will likely be additional curve flattening.

Portfolio Strategy

The environment we foresee in 2017, a flattening curve and modestly rising rates, is favorable to C.W. Henderson's approach to municipal portfolio management. The

employment of barbell structured portfolios and duration control dampens the impact of rising interest rates and typically produces strong relative returns compared to market indexes. Exposure to longer securities has been limited during the low rate environment over the past few years but was recently increased marginally to take advantage of higher prevailing yields after the November rate surge. Portfolio durations are currently targeted at 3.8 years, up from 3.4 years, but still about 10% below neutral.

The benefit or our active management was evident last year with accounts accruing positive gross returns while the primary benchmark we monitor, the Barclays 5 Year GO Municipal Index, had a negative 0.52% return. We have produced similar comparisons in almost every period of rising interest rates and/or Fed tightening over the past twenty-five years. We would be pleased to share these results with anyone who has interest.

In addition, the spurt in interest rates after the election provided an opportunity to engage in tax loss harvesting that generated capital losses without compromising portfolio positioning. These losses are available to offset capital gains in other components of clients' overall portfolios or carried forward for use in future years. Potential tax savings accruing form last year's tax loss trading produced an average 0.51% tax-adjusted benefit. This significant result is not reflected in our reported performance statistics.

Tax Reform

As noted above, we expect that tax reform legislation will emerge from Congress sometime this year. President-elect Trump and House Speaker Congressman Ryan, with House Ways and Means Chairman Kevin Brady, have each provided outlines and consider tax reform a priority. Both plans would reduce the number of tax brackets from seven to three with rates of 12%, 25% and a top 33% rate, down from the current 39.6%. Capital gains and qualified dividends would be taxed at 0%, 15% or 20% under Mr. Trump's plan while the Ryan proposal has effective rates of 6%, 12.5% and 16.5%. Both plans eliminate the 3.80% surtax on investment income and the alternative minimum tax. To compensate in part for lost revenue, both plans restrict deductions. The Trump plan limits deductions to $100,000 for single payers and $200,000 for joint filers. Mr. Ryan's plan eliminates all deductions except for mortgage interest and charitable gifts.

Tax reform proposals that have been put forth are opening gambits and very unlikely to resemble ultimate legislation. Some lowering of the maximum personal rate is likely, but to what level is unknown. Deduction limitations will be proposed, but powerful lobby interests will actively fight for retention of vested interests. Mortgage interest deduction to stimulate home ownership, corporate deduction of employee health care coverage to moderate medical expenses, charitable giving to foster philanthropy and the municipal tax exemption. Governors and mayors who are struggling with limited budget flexibility arising from growing health care expenses and underfunded pensions are certain to aggressively oppose actions that increase their cost of capital. The U.S. Conference of Mayors, the Government Finance Officers Association and Association of State Treasurers are all actively engaged in efforts to preserve the tax exemption.

Whether municipal officials prevail in their effort remains to be seen but there are strong arguments in favor. Budgetary challenges mentioned above top the list. Second, lost revenue to the federal government due to municipal tax exemption is modest compared to the mortgage interest and employee health care deductions. Third, if infrastructure rebuilding is a national priority, it is imperative that enthusiastic state and local governments be engaged in this effort. Most infrastructure projects are initiated and, to a

significant extent, financed by state and local governmental entities. Washington is not the best place to decide which schools need upgrading, water mains need repair, roads widened and resurfaced, bridges replaced, etc.

A lower corporate tax rate has also been proposed by Mr. Trump with the rate dropping to 15% from the current 35% level to stimulate domestic capital spending and the repatriation of capital from overseas subsidiaries back to the U.S. A significant reduction in the corporate tax rate, along with regulation reform (Graham Dodd, Volcker Rule) would likely reduce corporate appetites for tax-exempt income with banks and casualty insurers reevaluating their investment programs. These corporations currently hold about 30% of outstanding municipal securities and their demand provides a buffer when tax exempt mutual funds are experiencing outflows. Lessened corporate participation in the market would likely translate into somewhat higher rates, increased retail ownership of municipal securities and an increase in market volatility.

Possible Outcomes

- Lower personal and corporate tax rates. High probability. Municipal rates rise to compensate.
- Reduced personal exemptions. High probability. Whether tax exempt interest would be included in the cap is uncertain.
- Reduced taxes on dividends and interest. Probable. Value of tax-exempt interest reduced.
- Elimination of municipal tax exemption. Low probability. However, there could be restrictions on private activity securities, advance refundings, etc.
- Elimination of future tax-exemption but existing bonds grandfathered. Unlikely, but possible. Value of existing bonds would be enhanced.

With the ratio of ten year prime municipal to Treasury yields at about 94%, much of the uncertainty surrounding potential tax reform appears to be priced in the market. We will monitor legislative developments as the year progresses.

Firm News

We are proud of our accomplishments in 2016. Continued growth in assets under management, strong relative returns and aggressive tax loss trading combined to create a very successful year. We once again want to express our appreciation for the continued support of our clients and friends.

We are pleased to announce that Jenny Horne has joined C.W Henderson & Associates as the new office coordinator. Jenny is a recent graduate from the University of Illinois. Welcome aboard.

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

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