*The Investor's Edge*

# *C.W. HENDERSON & ASSOCIATES, INC.*

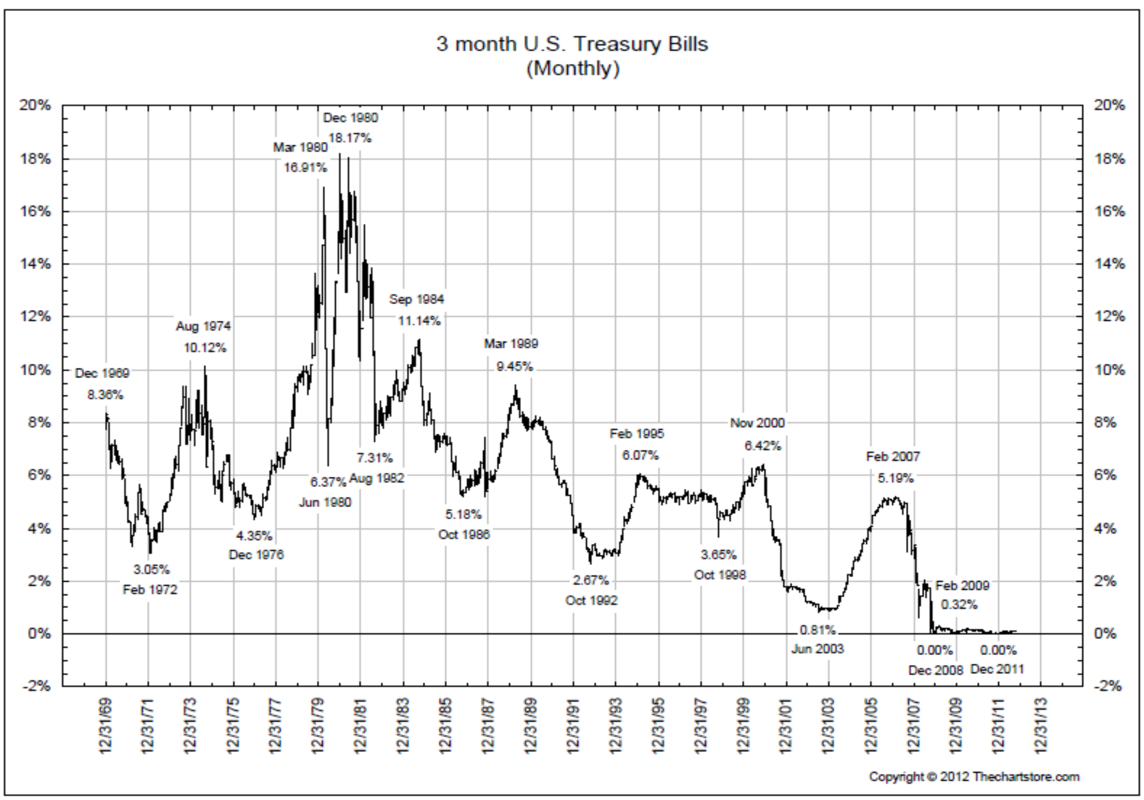
***Investment Managers Specializing in Tax-Exempt Municipal Securities***

- **Background and Outlook** **OCTOBER 2012**

The third round of quantitative easing is now a reality with the Federal Reserve slated to purchase $40 billion mortgage backed securities per month and continue Operation Twist until the unemployment rate drops substantially. Current planning also calls for short rates to be maintained near zero through mid 2015. Monetary policy is now well defined, but the fiscal picture is anything but clear with political rancor continuing and tax increases and spending reductions slated to take effect on January 1st. With forecasts indicating that the "fiscal cliff" would all but eliminate economic growth next year, we expect that Congress will take steps after the election to moderate its impact. The form of that action will remain uncertain until the Presidency and the makeup of Congress are determined. However, we expect that most of the spending cuts and tax increases will be postponed either by the lame duck Congress late this year or by the new Congress in early 2013. The more important question is whether economic growth can accelerate next year from the modest pace currently being recorded. Our expectation is that growth will remain positive but sluggish for several more quarters as consumers continue to struggle with underwater mortgages, job uncertainty and limited wage gains.

The following chart, courtesy of The Chart Store, provides a long term picture of short interest rates as represented by the Three Month Treasury Bill. The recent yield on this instrument was 0.10% and reflects Federal Reserve policy that is targeting the Fed Funds rate between zero and twenty-five basis points.

Data as of September 2012

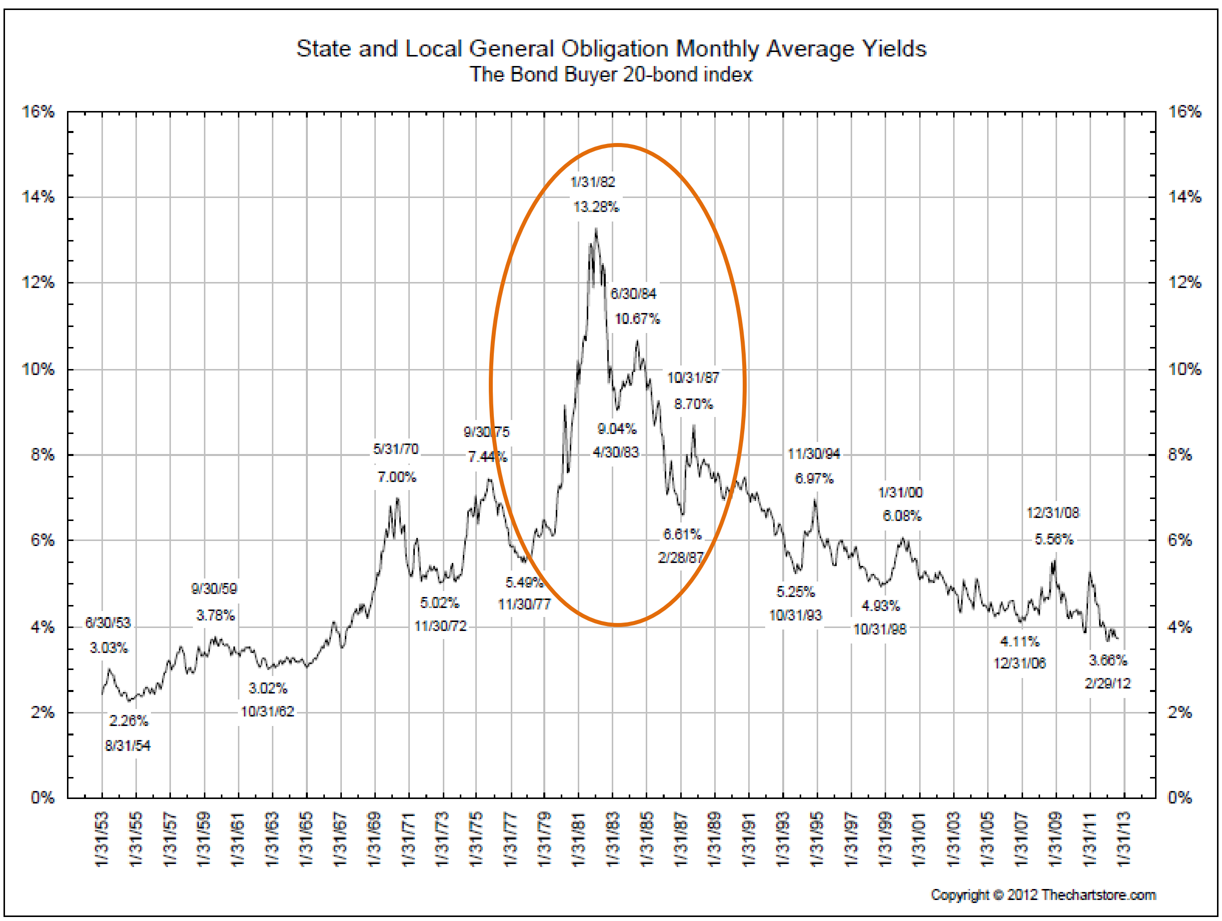


The basic rule of not fighting the Fed remains relevant. Chairman Bernanke has clearly stated that the Fed plans to provide massive liquidity for the foreseeable future. Longer interest rates are likely to remain somewhat volatile, but movements to higher levels should be contained and, in fact, rates could move still lower as the Euro crisis and saber rattling in the Middle East prompt investors to opt for the safety of U.S. Treasury investments. However, low yields produce extended durations and heightened susceptibility to interest rate shocks. In the current environment, a one hundred basis point upward move in interest rates would drive the price of a high quality, non callable, ten year municipal bond down by about 8%. Given that risk, we continue to feel that caution is called for. Portfolio durations are being maintained at approximately 3.6 years, about 15% below neutral. An acceleration in economic growth or signs of building inflation would cause us to consider moving durations still lower.

- **The World Thirty Years Ago**

In many respects we are now experiencing the flip side of the financial environment that existed in the early 80s. At that time inflation had surged to double digit levels and the markets were in turmoil. The stock market had been stagnant through much of the 70s while interest rates ramped higher in response to surging inflation. Paul Volcker, the then newly appointed Chairman of the Federal Reserve, vowed to calm inflation by controlling monetary aggregate growth, not by targeting interest rates. Reduced liquidity caused the yield curve to invert as the Federal Funds rate was driven above 20% while long Treasury yields rose above 15%. Prime municipal yields were close behind. Investors with existing bonds shifted their focus from yield generation to protection of principal. Dramatic volatility ensued but Chairman Volcker's persistence ultimately brought inflation under control which, along with the end of the Cold War and the emergence of the tech industry, set the stage for years of sustained economic growth, declining interest rates and advancing stock prices.

Data as of September 2012



The current environment will also adjust over time to a more "normal" state. Deleveraging can be an extended process but it will ultimately end. Our concern is not with where we are headed, but rather with the timing and orderliness of the adjustment process. Volatility and interest rate shocks are very possible when the Fed unwinds its massive balance sheet. Limiting duration exposure and maintaining liquidity remain prudent tactics in the current low rate environment. Shorter durations limit volatility exposure and provide flexibility to invest advantageously when rates rise.

- **Ability to Pay / Willingness to Pay**

Investors have long purchased municipal general obligation securities with the belief that state and local government officials would do their utmost to honor the "full faith and credit" pledge accompanying their securities. That confidence has recently been challenged to some degree.

Our last newsletter discussed the financial strain Stockton, California is dealing with and the City's decision to initiate bankruptcy proceedings. Infrastructure building during the 2003 to 2009 timeframe dramatically increased the City's debt load and debt service burden. Interest expense this year is 600% of the amount paid in 2007 due to the back-loaded structure of debt that was issued on the assumption that revenues would continue to increase over time. On the contrary, the recession precipitated a 70% decline in property values and soaring unemployment. Despite dramatic cuts in employee levels and other operating expenses, the City continues to face significant projected deficits. Stockton follows Vallejo which recently exited from a long bankruptcy ordeal. Stockton is now joined by San Bernardino, Mammoth Lakes and Compton that have all filed or indicated that they will likely file for bankruptcy. Atwater, California (population 28,000) is a recent addition to the potential Chapter 9 filing list.

Are municipal officials now viewing bankruptcy similarly to a corporate restructuring, as a means of attaining protection from creditors and a tactic to extract concessions from employees, service providers and creditors – including bond holders? Perhaps to some limited extent. Is the number of filings likely to multiply dramatically? We don't think so. Most municipal officials have made the difficult decisions necessary to maintain fiscal integrity and honor government commitments. We expect that they will continue to do so. The number of defaults in the municipal arena remains very low and primarily related to failed enterprise operations; sports arenas, parking facilities, convention centers, solid waste disposal facilities, etc. that proved to be economically unsustainable. A recent Moody's report indicated that although the incidence of defaults and bankruptcy filings may rise, they anticipate that most problems will continue to be concentrated in enterprise projects that have become uneconomic. However, the decisions by Vallejo, Stockton, San Bernardino, etc. have prompted the rating agency to closely monitor developments regarding long held willingness to pay assumptions. What is clear from all this is that credit monitoring has become ever more critical. We are maintaining high credit standards and avoidance of the types of enterprise credits mentioned above.

- **Build America Bond Rebates Could Be Reduced**

BABs were a creation of the American Recovery and Reinvestment Act that allowed municipalities, in 2010, to issue taxable bonds and receive a rebate from the federal government equal to 35% of the interest expense. If action is not taken by Congress to defer or soften the fiscal cliff, the rebates would be reduced by sequestration. An Office of Management and Budget report indicated that the rebates would be reduced by 7.6% (rebate rate reduced to 32.3% from 35%). It is estimated that this would reduce total rebate payments by $255 million.

As stated earlier, we anticipate that steps will be taken to avoid the fiscal cliff. Even if sequestration does take place, this action is unlikely to have a significant impact on the financial condition of the vast majority of the municipalities that issued BABs. It does, however, raise an issue of whether these bonds could be called under extraordinary call provisions that allow issuers to retire bonds if Congress makes changes that impact these securities. Given the sharp decline in interest rates since these bonds were sold, there could be an incentive to refinance. Two issues stand in the way. First, refinancing taxable debt with tax-exempt securities may not be allowable under current tax law. More importantly, most of the BABs bonds were issued with make whole call provisions where applicable call prices are adjusted to compensate bond holders for lost interest. This translates into very high call prices that, in most cases, make early retirements uneconomic.

- **Berkshire Hathaway Unwinds Municipal Credit Default Swaps**

It was reported in late August that Berkshire Hathaway terminated $8.25 billion of municipal credit default swaps five years before termination. The swaps were purchased by Lehman Brothers in 2007. The impression presented by the media is that Berkshire Hathaway's action was precipitated by increased risk in the municipal market.

This conclusion is not necessarily correct. The counterparty for the terminated swaps was no longer Lehman Brothers but Lehman Brothers Estate. It has been reported that the Estate has been attempting to close out the trades since early 2009 but was challenged to do so because of the trade's large size and limited liquidity in the municipal CDS market. The swaps reportedly covered fourteen states, but the credits involved and respective exposure levels are unknown. Also unknown were the terms of the swaps and whether they were profitable for Berkshire Hathaway. Berkshire has an equal amount of swaps covering a broad array of credits that remain outstanding. There has been no indication that Berkshire is considering early termination of these swaps.

- **Status of Municipal Bond Insurers**

Prior to 2008 over half of the municipal new issues marketed were insured. Retail investors seeking safety and peace of mind generally opted for the additional protection offered by insurance. Dominating the market at that time were MBIA, FGIC, Ambac, FSA and Assured Guaranty. Smaller players XLCA, Radian, ACA, Syncora and CIFG were also part of the landscape as well as Berkshire Hathaway, a late entrant. Other than Radian and ACA, all of the insurers originally had AAA ratings from all three rating agencies, Moody's, Standard & Poor's and Fitch. Most of the companies expanded their coverage in the early part of the last decade beyond the municipal space into other market sectors including mortgage backed and other asset backed securities. Losses in these non-municipal sectors when the markets imploded in 2008 caused several firms to fail. In the survivor category is Assured Guaranty that merged with FSA and also assumed CIFG's portfolio. The resulting firm now carries Aa3/AA-/NR ratings. Berkshire Hathaway is now inactive but rated Aa1/AA+/NR. MBIA (now National) carries Baa2/BBB/NR ratings. All other firms are unrated or carry non-investment grade ratings. Insured new issues represented only about 5% of the market last year.

A new insurer, Build America Mutual (BAM), recently began operations and has written its first policy. Whether investor confidence in bond insurance can ever be restored to any meaningful degree remains to be seen. Whatever the outcome, we continue to counsel that only insured bonds with sound underlying credits be considered for purchase. This approach served our clients well in 2008.

We expect that media coverage of the municipal market will continue. Please call or email either of us or Matt Andrews with any questions you may have (chenderson@cwhenderson.com, tmallman@cwhenderson.com, mandrews@cwhenderson.com).

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