The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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- **Fiscal Cliff Averted**

An agreement was reached in the closing hours of 2012 through negotiations by Senator McConnell and Vice President Biden that avoided the fiscal cliff. The bill was strongly backed by the Senate and subsequently passed by the House. This legislation limits middle income earners' tax increases, restricts the reach of the alternative minimum tax, postpones dramatic spending cuts, prevents sequestration, etc. The markets expressed a collective sigh of relief that sent equity prices sharply higher.

As anticipated, wealthy individuals will be subject to higher taxes. The top personal tax rate for singles with incomes over $400,000 or couples with income in excess of $450,000 will rise to 39.6%. Phase out of deductions (mortgage interest, property taxes, state income taxes and charitable deductions) will push the effective rate higher. In addition, the 0.9% Medicare charge on earned income and 2% increase in FICA will add further to the tax burden.

Federal revenues will be bolstered, but missing from the bill are serious budget cuts or entitlement reforms while tax subsidies for various special interests were maintained. Unless subsequent negotiations reduce spending or economic growth is higher than anticipated, significant deficits will continue to be incurred. Additional negotiations will take place in a few months as the debt ceiling is neared. More Washington drama seems assured.

The tax on long term capital gains and on dividends both increased to 23.8%. Each rate moved from 15% to 20% and both are subject to the 3.80% surcharge that is a component of the health care legislation. Realization of capital gains in 2012 has proven to be beneficial.

The good news, as of now, is that municipal income remains fully exempt from federal taxation. Whether this continues to be the case or a limitation is imposed as budget discussions continue (e.g. 28% limit) remains to be seen. We continue to expect that interest from existing bonds will be grandfathered if limitations are imposed, but nothing is certain. For the moment, investor interest in tax exempt securities has been bolstered due to the tax rate increase.

- **Interest Rate Outlook**

As indicated in the following table, the municipal market rallied during most of last year except for a backup in December.

AAA Tax Exempt Yields

	12/31/12	11/30/12	9/30/12	6/30/12	3/31/12	12/31/11
1 Yr	0.21%	0.20%	0.19%	0.20%	0.21%	0.19%
5 Yrs	0.79	0.56	0.63	0.82	1.00	0.84
10 Yrs	1.70	1.36	1.66	1.85	2.10	1.81
15 Yrs	2.13	1.82	2.10	2.45	2.71	2.66
20 Yrs	2.44	2.12	2.42	2.78	3.06	3.18
30 Yrs	2.84	2.45	2.82	3.11	3.38	3.48

Where do we go from here? Our economic and interest rate outlook remain essentially unchanged from last quarter. Despite somewhat of a resurgence in housing, individuals remain burdened with excessive debt, high unemployment and limited wage growth. We expect that this environment will persist in the coming months which, combined with reductions in disposable personal income due to increased taxes, will limit consumer spending. Corporate balance sheets remain healthy but continued uncertainty regarding taxation and regulations, combined with slowing global growth, will likely restrict capital spending. Given this background, we anticipate that economic growth will remain positive, but muted.

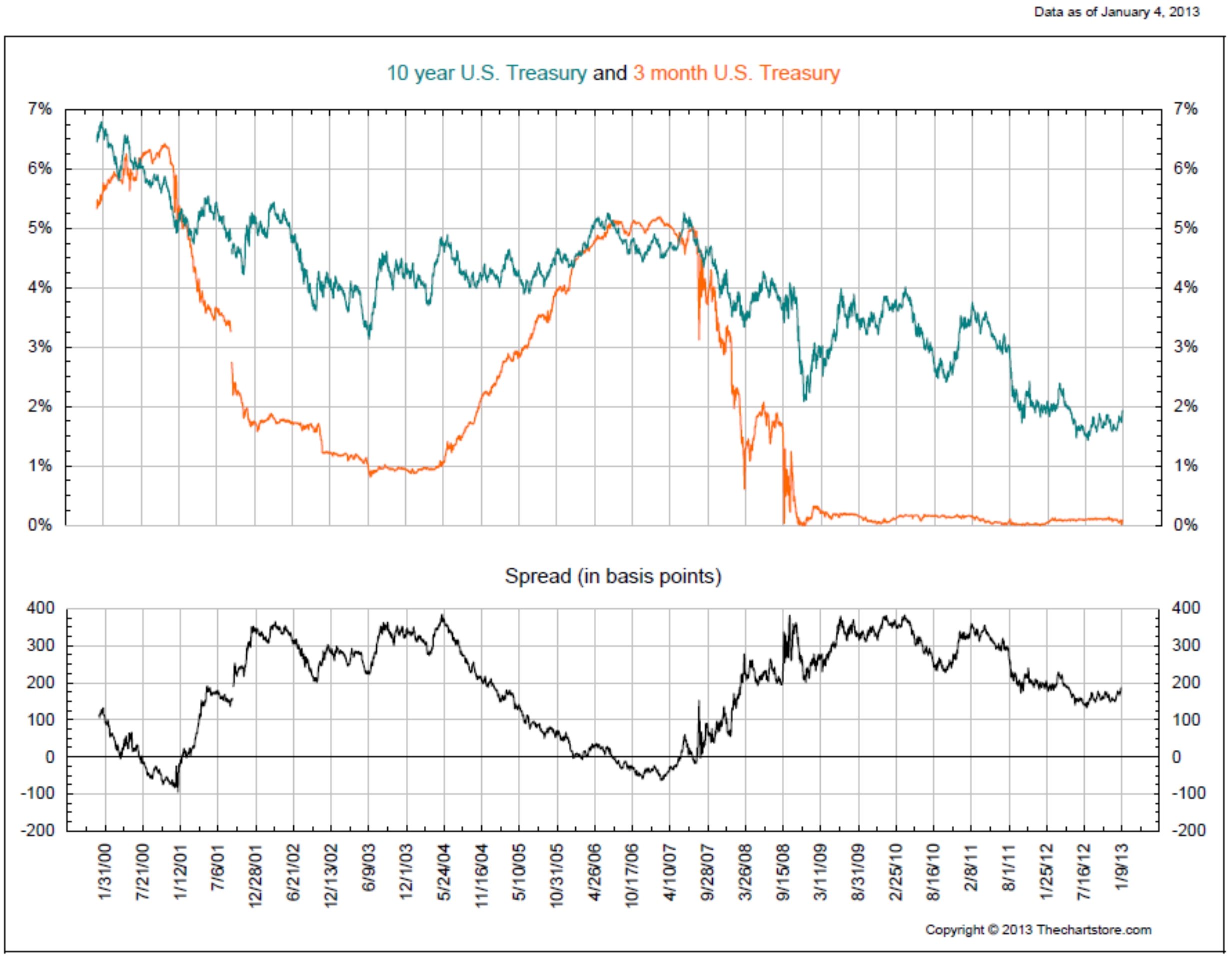
Despite indications in the recent FOMC minutes that the Committee is not in full agreement as to whether quantitative easing should continue at the current pace, we expect that the Fed's accommodative posture will be maintained with short rates kept near zero combined with additional QE purchases of mortgage backed and Treasury securities. The Fed's strategy of maintaining ease until the unemployment declines to 6.5% or below remains in place. We anticipate limited near term interest rate movements in this environment. Municipal rates will follow the Treasury market's lead, but will also be influenced by the level of supply (estimated to total $350 to $400 billion this year) and, more importantly, by future tax policy discussions. Ten year prime tax-exempts are currently yielding 93+% of the like maturity Treasury rate, in line with where municipals have been trading in recent months.

Regardless of what unfolds in Washington and the economy, the low level of nominal rates continues to call for a degree of caution. Portfolio durations remain targeted at 3.60 years, a conservative level compared to our neutral posture of 4.20 years. Signs of accelerating growth or a resurgence of inflation would prompt us to further reduce portfolio interest rate sensitivity. We continue to focus on purchasing and holding bonds with strong credit characteristics.

- **Longer Term View**

If the Fed's purchases of Treasury and mortgage backed securities continue at the current pace, their balance sheet will balloon further to near $4 trillion by the end of this year, up from less than a trillion dollars prior to the onset of the quantitative easing programs. The nagging question on investors' minds is, "How will the Fed's holdings ultimately be unwound?" Given the Fed's objective of maintaining ease until the economy strengthens, this is not a near concern. Projections suggest that the central bank's balance sheet holdings are likely to be retained through much of the decade rather than liquidated. The bigger question is when will the Fed curtail its quantitative easing program and stop the balance sheet expansion? Removal of their buying support will likely cause longer interest rates to move higher. Again, probably not a concern this year, but investors need to keep a watchful eye for any indication of a shift in the Fed's posture.

The chart below illustrates the levels of ten year and three month Treasury rates since the beginning of the last decade along with the yield spread between these sectors. A move back to the average level of the ten year Treasury since 2000 would involve a backup of two to three hundred basis points.



- **Rising Rate Portfolio Impact**

We have received several inquiries regarding the vulnerability of the portfolios we manage to rising interest rates. As mentioned earlier, we do not anticipate a dramatic rise in rates this year. However, we are mindful of volatility risk and have shortened portfolio durations from the normal modest levels to even more conservative positions to provide an added degree of insurance.

To test our clients' exposure to rising rates, we performed simulations on a typical portfolio and assumed a 100 basis point parallel shift in interest rates over one year and a two hundred basis point rise in two years. In both instances, assuming we did nothing, total return portfolio losses would be less than 1%. However, as active managers we would shorten durations to counter rising rates, take advantage of market disparities that typically develop during periods of market uncertainty, harvest tax losses that can be used to offset current or future gains, etc. Given our conservative approach to investing, our relative performance is typically best in rising rate environments. We feel that we can continue this track record.

Our more immediate focus continues to be on assuring that the credits we hold are high quality. In general, municipal finances have improved, but stress continues. It is vitally important that credit quality standards be maintained and that existing holdings be periodically reviewed. Red flags associated with a few holdings prompted us to eliminate those positions over the past year.

- **Risk of a U.S. Downgrade**

Soaring federal deficits prompted Standard & Poor's to downgrade the U.S. to AA+ from AAA last year. Moody's has warned that they might take similar action if deficits persist. Tax legislation enacted at the end of the year should forestall any immediate action by the rating agencies, but the debt ceiling negotiations and future spending are sure to be closely monitored.

Concern for fixed income investors relates to the sovereign rating and also to the ratings of sub-sovereign credits. Will/can the rating agencies maintain higher ratings on state and local credits if the U.S. loses its prime rating? AAA credits like the Commonwealth of Virginia, State of Maryland, etc. could be impacted. Hopefully Washington will take action to put the federal budget on a sound long term footing and eliminate the possibility of venturing into this uncharted territory.

- **Pensions and Chapter 9 in California**

As reported in previous newsletters, severe financial strains have prompted Stockton and San Bernardino in California to enter into bankruptcy proceeding. In each case, California Public Employee Retirement System (CalPERS) is claiming that funds owed to the retirement system have a prior claim on revenues over other obligations, including debt service on outstanding bonds. CalPERS is arguing that public worker pensions are protected by the state constitution contracts clause and have primacy over other creditors. Bond insurers AMBAC Assurance Corporation and National Public Finance Guarantee Corp. along with Wells Fargo, trustee for San Bernardino's pension obligation bonds, have filed a motion contesting CalPERS' position. This action was followed by a San Bernardino bond holders' protest. It remains to be seen how the bankruptcy courts will rule. The cloud precipitated by CalPERS' action has prompted us to review non-state California general obligation holdings and dispose of those with potential risk.

- **Firm News**

The start of a new year is a time for review and planning. The potential for additional tax legislation that could disrupt the municipal market exists but, despite whatever happens in Washington, municipalities will need to finance infrastructure projects and investors will need fixed income securities in their portfolios. C.W. Henderson remains committed to providing conservative municipal bond management. We once again thank our clients and friends for the support provided during the past year and wish you a happy, healthy and prosperous 2013.

Craig W. Henderson **Thomas L. Mallman, CFA**