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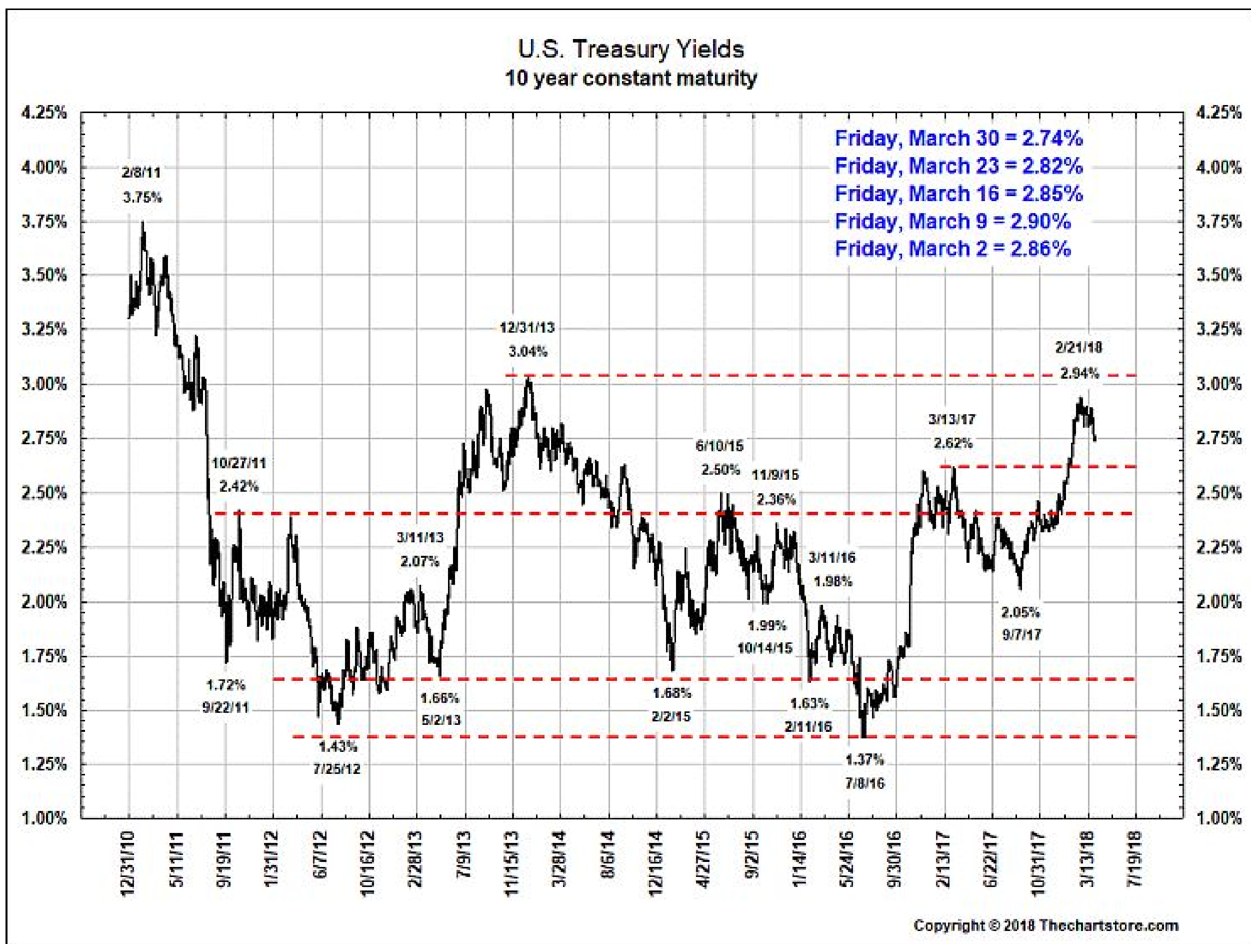
C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING
IN TAX-EXEMPT MUNICIPAL SECURITIES

The Investor's Edge

Background and Outlook

Fears of accelerating wage pressures that could push inflation rates higher pressured the fixed income markets during the past quarter. The ten year Treasury yield rose sharply from the 2.40% level at the start of the year to near 3.0% in February before settling at 2.74% at the end of the quarter. Concern that the Federal Reserve might accelerate their tightening program beyond three moves this year added to market nervousness.



Real GDP growth is expected to continue to advance at a two plus percent rate for the foreseeable future despite the near record length of the current expansion that passed the 105 month mark in March. Forecasts are calling for additional employment gains with the unemployment rate falling below 4%. The Federal Open Market Committee doesn't, at this point, feel that the economy is overheating and is following their game plan of periodic quarter point increases in the Federal Funds rate. The latest increase in mid-March brought the targeted range to 1.50% to 1.75%. Two additional increases this year remain in the game plan to be followed

by further tightening in 2019. Thus far inflation pressures have remained docile with a year-over-year 2.20% increase in the CPI through March. The Fed's preferred inflation measure remains below 2.0%.

Pressure on longer rates should remain contained over the near term in the moderate inflation environment. The Treasury curve is currently providing positive real returns for two year and longer maturities compared to the trailing annualized CPI rate of change which bolsters the argument for longer rate stability. Short rates will continue to move higher as the Fed tightens. Additional yield curve flattening is expected.

We are keeping a watchful eye for indications of inflationary pressures that could undermine our market view. However, with account durations targeted at 3.80 years, any unanticipated upward rate move should not have a dramatic impact on portfolio valuations.

We are cognizant that the volatility experienced in the equity markets in recent months is having a spillover effect in the bond market. Turbulence resulting from trade disputes, immigration debates, special council Mueller's investigation, North Korean belligerence, Russian meddling, etc. have impacted equity valuations and investors' risk tolerances to some degree. A preference for safe harbor investments will benefit high quality fixed income investments, but increased volatility is likely to persist in all market segments.

Limited Municipal Supply

The Tax Cuts and Jobs Act enacted late last year eliminated municipalities' ability to issue tax exempt refunding bonds beyond the end of last year. The resultant rush of financings prior to year-end caused a surge in supply that brought 2017 new issue volume to a near record $438 billion. As anticipated, volume dropped dramatically in the first quarter of this year and totaled $62.8 billion, a 32% decline from the first quarter of 2017. We anticipate continued sluggish new issuance throughout the year.

Retail demand for tax-exempt securities remains robust which will continue to buoy the municipal market, especially with reduced supply. In contrast, the reduction in the corporate tax rate from 35% to 21% makes municipals much less attractive to banks and property and casualty insurance companies. In addition, a change in FASB rules altered favorable accounting for banks holding long maturity premium bonds with short calls. Portfolio liquidations by both banks and insurance companies have been evident during the quarter.

Despite lessened corporate demand, a robust appetite for tax-exempt income by individual investors through mutual fund investments and structured bond portfolios should easily absorb available supply.

C.W. Henderson's medium size compared to many large competitors allows us to remain selective in the bonds we purchase, which is especially important in periods of limited supply. Only bonds with desired credit quality and structures we desire are selected for client portfolios. Some larger firms have lowered quality standards to increase the universe of potential bonds they can purchase. In contrast, we are becoming more selective due to narrow credit spreads.

Heavy Treasury Supply

In contrast to the municipal market, Treasury financing will be robust. The $1.5 trillion tax cut must be financed at the same time the Federal Reserve is paring its balance sheet. Some forecasters have estimated that $2 trillion Treasury securities will need to be marketed in FY 2019. In regard to demand, uncertainty is building as to whether trade disputes will dampen foreign central banks' historically strong appetite for

Treasury debt. Some pressure on government rates seems possible with carry over into the municipal market. However, the favorable supply/demand balance in the tax-exempt sector should moderate upward rate moves in the municipal market.

Advantage of Tax Loss Harvesting

As shown in the table below, prime tax-exempt rates moved higher during the quarter with longer rates peaking in mid-March. We took advantage of the rate increase to swap bonds and generate capital losses in client portfolios wherever beneficial to do so.

AAA Tax-Exempt Yields

	3/29/18	3/14/18	12/31/17
1 Yr.	1.56%	1.48%	1.41%
5 Yrs.	2.04	2.01	1.66
10 Yrs.	2.44	2.54	1.98
15 Yrs.	2.67	2.77	2.25
20 Yrs.	2.80	2.90	2.40
30 Yrs.	2.93	3.03	2.52

The process involves screening all client accounts to determine holdings that qualify for tax loss trading. The assemblage of relevant securities is then reviewed to determine how they should be swapped between accounts. The focus is on creating tax losses while also maintaining appropriate account arrangements (barbell portfolio structures, high quality securities, targeted durations, etc.). To assure that trades create valid tax losses, a bond that is sold must be replaced by another similar, but different, security that has two or more coupon, credit or maturity differences. For example, an Austin, Texas 5% bond with a fourteen year maturity could be replaced with a like maturity Dallas bond with a different coupon. We pay strict attention to details of the bonds swapped between accounts to assure the validity of the tax loss transactions. Market prices are used to determine trading levels and trades are settled through brokers.

To understand the math underlying the process, consider the following example. Assume a AA rated bond with a 5% coupon due in 15 years with a ten year call was purchased early this year at a 2.30% yield to call (3.00% yield to maturity). The dollar price of the bond would have been 123.97. Assume ten year interest rates move 50 basis points higher as was generally the case in mid-March compared to year end levels. The yield to call on the bond would increase to about 2.80% and the dollar price would fall to 118.72. This price move allows the bond to be swapped with a similar, but slightly different, bond from another client account with capital loses.

The resultant 5.25 point decline (123.97 – 118.72) would create a 4.24% short term tax loss. Assume that 15% of a client's portfolio had eligible swap securities that generated losses of this magnitude. The loss applicable to the client's portfolio would be 64 basis points (4.24 X 0.15). This short term loss can be used to offset gains in the client's overall portfolio. The "tax adjusted" impact on the C.W. Henderson account would be a 25.5 basis point benefit assuming a 40% marginal tax rate (64 X 0.40). This benefit is not included in the performance reported for the accounts we manage but is an extremely valuable component of the tax focused portfolio management we provide.

A point to keep in mind is that the availability of tax loss eligible securities is not uniform across all accounts. Accounts that opened or added funds during relatively high rate environments will have fewer losses than those started when prevailing rates were lower. However, the variability of tax loss opportunities among accounts diminishes over time in situations where we have management authority in long-term client relationships.

C.W. Henderson Short Term Product

C.W. Henderson's short term product is designed to provide exposure to the short duration segment of the market and provide returns that exceed money market yields with portfolios that have limited price volatility.

Returns were constrained while the Federal Reserve held the Fed Funds rate near zero from late 2008 until their first adjustment in December 2015. Five additional moves have brought the targeted Fed Funds rate to the 1.50 – 1.75% range as noted earlier. Short municipal yields have moved commensurately with one year high quality securities being offered at yields of 1.50% to 1.60%. Additional yield increases are anticipated as the year progresses which will further increase the attractiveness of the product. Returns have been positive as the Fed has increased rates. This vehicle provides an alternative for investors seeking tax exempt income in a short duration product and for those wanting a safe harbor alternative to avoid capital market volatility.

Credit Challenges

C.W. Henderson has consistently invested only in high quality, liquid securities in client portfolios in accord with the Firm's focus on risk control. Lower quality securities acquired with new accounts have always been expeditiously liquidated, especially in regard to Puerto Rico bonds. Our action has helped numerous clients avoid significant losses.

Even without direct exposure, developments in Puerto Rico can have a spillover impact on the broader municipal market. A recent court opinion held the Puerto Rico Highway Transportation Authority (a government owned enterprise with bonds backed by user fees) was not obligated to make debt service payments during the course of a Chapter 9 bankruptcy. The opinion is being appealed, but does raise an issue regarding assumed bond holder protection in the broader municipal market.

Developments in Puerto Rico have little if any meaningful impact on the credits we hold, but reinforce the need for close surveillance of the entire credit landscape and client portfolio holdings. Only municipalities and municipal entities with strong fundamentals are considered for use in client accounts and all holdings are reviewed at least annually to assure that credit integrity has not diminished.

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