RIVERBEND
Capital Advisors

Market Comment 5/23/14

Surprise!

So far 2014 has not played out in the bond market the way many prognosticators and experts had predicted. A few months ago, the consensus seemed to be that interest rates would rise this year and fixed income performance would be flat to negative. The U.S. economy was picking up and Fed tapering was underway. For munis, these dynamics were just part of the somewhat dreary outlook. Additionally, municipal bond mutual fund outflows were at record levels in 2013 and redemptions were continuing, albeit at a slower pace. The tentative treatment of Detroit general obligation bondholders was creating uncertainty about bankruptcy recovery rates and the value of GO backing. Puerto Rico and its $70 billion in outstanding bonds seemed headed for the abyss. Yet the municipal bond market has performed like a champ in 2014, up more than 5% year-to-date based on broad market intermediate and longer-term indexes. Last year's losses have been erased, and then some. How did it happen?

Supply

The most commonly cited explanation is diminished muni supply. Through April 30th new issuance is down by 33% year over year. We're currently experiencing the lowest volume in nearly 20 years. The dramatic decline can be attributed to a variety of factors. While borrowing rates for states and municipalities are fairly low, they are significantly higher than they were in the first few months of 2013. Much of last year's issuance was refunding, essentially municipalities refinancing older outstanding bonds with new bonds at lower rates. These refinancing's don't work as well when rates rise, and as a result refunding activity is down more than 50% in 2014.

Austerity and alternate financing sources are also contributing to the decline in volume. The fiscally conservative approach to taking on debt that many states and municipalities have adopted since the financial crisis is an additional constraint on supply. Public support for borrowing is lacking, even when the purpose is infrastructure maintenance and improvement. Bond issues put on ballots for public approval are not passing as readily. While this behavior is generally credit-positive, it has contributed to the decline in issuance. Another component of the decline in new issue volume is the fact that some issuers (primarily health care, higher education, and local governments) are obtaining bank financing for projects. While not appropriate in all situations, bank loans are an alternative to issuing bonds.

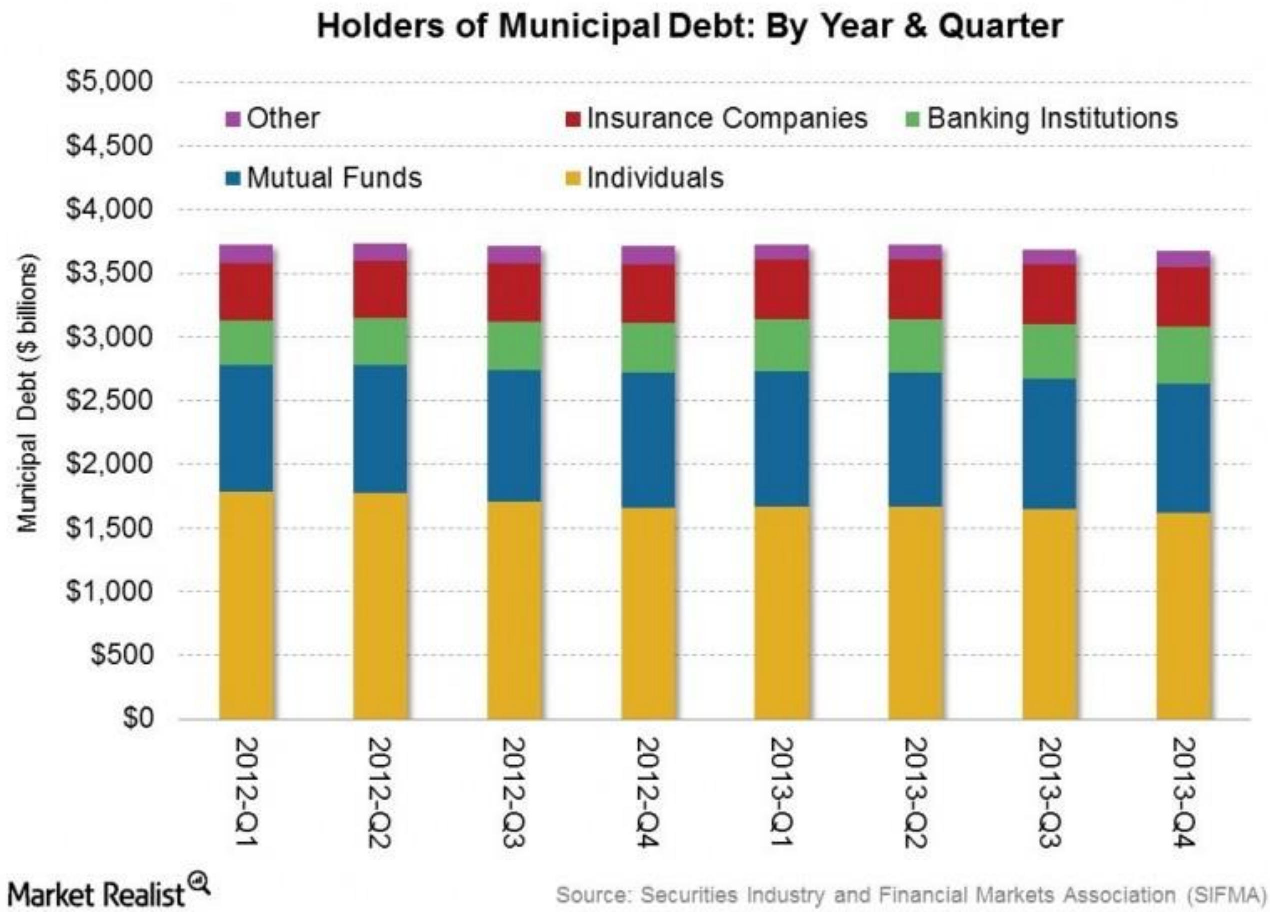
Demand

The drop in supply during 2014 has coincided with robust demand for the muni asset class. The market was oversold at the beginning of the year, with yields 100 basis points higher than early 2013. The latter half of 2013 was characterized by overblown fears about the impact of Fed tapering and the situations in Detroit and Puerto Rico. Scary headlines stoked anxiety for many retail investors, who in some cases sold bonds or liquidated muni fund holdings. The impact of these misguided concerns weighed heavily on the muni market, which experienced record fund redemptions in 2013. Negative fund flows turned positive in 2014, with net inflows during 14 of the last 20 weeks.

The Detroit bankruptcy "grand bargain" settlement currently in process would pay GO bondholders 74 cents on the dollar. Not the greatest, but a far cry from the 15 cent rate that was initially proposed by Emergency Financial Manager Kevin Orr last year. And although we're not positive about the long term prospects for Puerto Rico bonds, the Commonwealth was able to tap the market for $3.5 billion back in March. Puerto Rico's governor recently proposed the territory's first balanced budget in more than ten years. While we're content to watch how both situations play out from the sidelines, the market seemed to take some relief in these developments.

Credit fundamentals continue to improve, even though growth in tax receipts at the state level has slowed after 17 straight quarters of increases. It's important to keep in mind that the $3.7 trillion municipal bond market is not monolithic. Each sector has unique characteristics to consider. Local GO's tend to be dependent on property taxes. As housing values rebound in many areas of the country, these municipalities will gradually benefit. Essential service (water/sewer/utility) issuance may increase as needs become more pressing, despite volume being down substantially in 2014. Higher education is characterized by a widening dichotomy between large and small institutions. After decades of relentless increases in tuition rates and expenses and more questioning about the value proposition of some college degrees, smaller and lesser known private schools are facing challenging times. Larger hospital systems with regional or national presence seem most resilient in the changing healthcare landscape.

The impact of 2013 tax increases on muni demand cannot be underestimated. The top federal income tax rate went from 35% to 39.6% last year. A new 3.8% Medicare surtax on unearned income also went into effect. Muni interest is not subject to this tax. Many states raised income taxes. With these developments, the value of the tax-exempt status of muni income became more valuable. The recent tax filing season likely served as a wake-up call to many upper income Americans, inspiring renewed interest in tax-free munis.



Outlook

Yields are down from their most recent peaks, but higher than a year ago. Seasonality tends to be a factor in muni market performance around mid-year as June, July and August are heavy rollover months. Summer may see a continuation of muni supply constraints given that proceeds from the large volume coupon payments, bond maturities and calls will potentially be reinvested in the market. Muni/Treasury ratios are also lower, but could continue to grind if supply remains light. Muni performance is often technically driven, but the current pace is probably not sustainable given that the first half of the year has largely been a return to normal from a position of being oversold.

Assuming low supply is priced into the muni market, we're likely to be led by price action in UST's – subject to mixed domestic economic indicators, international concerns (ECB easing, Ukraine tensions, etc), short covering, and Fed policy adjustments. Bonds have rallied in 2014 while stocks have flirted with record highs. How might we expect high quality bonds to perform in the event of an equity market sell-off or correction later this year? The muni market is characterized by a large proportion of retail investor participation, either through direct ownership of individual bonds or via mutual funds. These investors tend to be attracted in calm markets and to overreact when confronted with volatility. We discourage market timing and suggest avoiding the herd mentality that has led to misguided panics among muni investors in recent years. Remember Meredith Whitney's predictions?? The 2014 muni rally provides investors with an opportunity to clean out riskier and/or less desirable positions, such as bonds with low coupons, long duration, short calls, lower-rated and weaker credits. We recommend defensive 5%+ coupons which perform better in a rising rate environment, positioning in the intermediate maturity range where the yield curve is steeper and there is more pick-up between maturities. Stay the course..

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