## Quarterly Review: A Tale of Two Sequestrations

The crisis in Cyprus and the ongoing debt issue in the US have different causes but the stark difference in response has been even more telling. According to the dictionary to sequester is "to isolate or hide away" and Cyprus certainly hid the fact their banks had exposure to a fair amount of Greek debt and that their assets had ballooned to nearly eight times their GDP making these institutions too big too fail. In response a rescue plan of 23 billion Euros was agreed to involving a bailout of ten billion Euros contributed from the Euro Zone Bailout Fund and the IMF with the balance of 13 billion Euros coming from a "bail-in" of Cyprus depositors in an equity swap arrangement. Cyprus's debt issue and dependency on foreign deposits is not a new story; however, the inaction of European leaders has done little to curb these issues. What makes the Cyprus situation troubling is that the large dependence on foreign deposits makes contagion a more likely scenario. In the US calls for reductions in government spending has become fever pitched throughout the recession. Towards the end of 2011 a Super Committee was formed in order to find $1.2 trillion dollar in cuts. The failure of this committee to reach any sort of "bipartisan agreement" placed increased pressure on fiscal cliff negotiations. While an 11th hour fiscal cliff deal was struck it merely delayed the inevitable. As the calendar turned to March the sequestered cuts, or automatic cuts to defense and other discretionary spending, were implemented. Regardless of what definition is used the austerity connected with these sequestrations may serve as a drag on the global recovery.

Revised fourth quarter US GDP numbers were reported at an annual rate of 0.4 percent, versus initial indications of 1.6 percent, which is in stark contrast to revised third quarter GDP numbers that increased by 3.1 percent. The fourth quarter numbers are a bit misleading considering the aggressive stance companies took in the fourth quarter as they accelerated bonus and dividend payments in anticipation of potentially higher tax rates. The Fed stated that the modest fourth quarter growth numbers was attributed to positive contributions in personal consumption, residential and non-residential investment and were offset by depressed spending by government, a downturn in exports and a negative contribution to private inventory investment. The Fed, in the hopes of keeping inflation at a level that maximizes employment while maintaining price stability, will continue its buying of mortgage-backed securities and longer term treasury securities. Additionally the Fed has reaffirmed its position of keeping the Fed Funds rate at or near zero for a prolonged period.

Domestically the news was mixed. Private payrolls showed continued growth albeit in ebbs and flows. January's gain was 177,000, February's gain was 237,000 and March's gain was only 158,000 jobs. The March numbers were almost 100,000 less than the economists forecast of 251,000. The slowing in March has been attributed to a construction slowdown as the rebuilding surge in the wake of Superstorm Sandy tailed off. Larger employers also slowed hiring in the wake of anticipation of additional costs, in part due to the implementation of healthcare reform. The unemployment rate continues to drop; however, this speaks to a disproportionate number of people no longer in the labor force. According to a recent study, the number of Americans no longer in the labor force has spiked to a record 90 million and the labor force participation rate plunged to 63.3 percent, the lowest since 1979. Personal income was another factor that ebbed and flowed in the first quarter as well. January's number reflected a decrease of 3.7 percent,

somewhat attributable to accelerated bonus and dividend payments paid out in December in response to potential tax increases.

As discussed in our previous Quarterly Review the economic slowdown in Japan was concerning and continues to be. Exports to the region from the US have slowed. In order to spur economic growth the Bank of Japan has taken an “unprecedented degree” of monetary easing by infusing $1.4 trillion of cash into the Japanese economy through a balance sheet expansion in which the Bank of Japan will buy government and private securities. This quantitative easing undertaken by the BoJ has rekindled currency wars both in the region and globally. Further exacerbating the global uneasiness is the Cyprus “bail-in”, which forced depositors to forfeit a portion of their funds, and the potential concern that the European debt crisis is far from over. What makes the Cyprus issue concerning is the deal which was struck has produced a more pronounced level of anxiety for depositors. Market uneasiness was not quelled when suggestions from Jeroen Dijsselbloem, Head of the Euro Zone Finance Ministers, that the Cyprus deal may be a template for other interventions if needed to bail out other institutions.

Municipal rates were mixed during the quarter due in large part to the lack of a budget deal and automatic across the board cuts enacted March 1st. Municipal yields were lower on the front end of the curve, dropping as much as 7 basis points, partly due to the Fed’s continued commitment to keep short term rates low through mid 2015. Municipal bonds maturing seven years and out saw yields increase as much as 13 basis points. Treasury rates followed municipals in tandem showing strength on the short end of the curve and weakness on the longer end. Municipal yields remain enticing to crossover buyers as ratios to Treasuries continue to be in excess of 100 percent across the entire yield curve.

| **US Treasury Yields** | | | |
|---|---|---|---|
| | 12/31/2012 | 03/28/2013 | Change |
| **1 Year** | 0.14 | 0.12 | -2 bps |
| **3 Year** | 0.36 | 0.38 | 2 bps |
| **5 Year** | 0.74 | 0.79 | 5 bps |
| **10 Year** | 1.81 | 1.92 | 11 bps |
| **20 Year** | 2.65 | 2.82 | 17 bps |
| **AAA Municipal Yields** | | | |
| | 12/31/2012 | 03/28/2013 | Change |
| **1 Year** | 0.21 | 0.18 | -3 bps |
| **3 Year** | 0.55 | 0.48 | -7 bps |
| **5 Year** | 0.90 | 0.90 | No Change |
| **10 Year** | 1.99 | 2.12 | 13 bps |
| **20 Year** | 3.03 | 3.14 | 11 bps |

A continued equity rally, with new highs in both the Dow and S&P Indexes toward the end of the quarter, compounded with low absolute yields and concerns surrounding the impact of sequester cuts to state and local municipal finances created some weakness in the municipal

marketplace towards the end of the quarter. For the first two months of the quarter, municipal bond fund flows were positive. This trend reversed course in March as market weakness along with earlier than the usual tax season selling, most pronounced on the long-end of the curve, contributed to the sell-off. Discussion on reducing or eliminating the municipal tax-exemption had quieted down in Congress until Obama's recent budget proposal which proposes to reduce the municipal tax exemption to 28 percent. However, the support to leave the exemption unchanged has become more vocal especially from municipal bond issuers themselves. Municipalities showed improving economic health in the fourth quarter with 44 states reflecting growth in employment and personal income. Every state reflected employment gains in the fourth quarter with the exception of Connecticut, Nebraska, Maine and the District of Columbia. Additionally, payrolls rose in 42 states as well. Through February total new municipal bond issuance was reported at $41.4 billion, a 5 percent increase from the same period one year ago. Continuing the 2012 trend, $32.1 billion of total municipal issuance has been for refunding purposes as issuers continue to take advantage of the low rate environment. Going forward we will remain diligent in assisting our clients in meeting their objectives.