RBAM Quarterly Commentary- Q1 2014- Navigating the News

The first quarter of 2014 did not suffer from a lack of interesting developments. Among which included heightened tension due to the annexation of Crimea, a dearth of new bond issuance which pushed the typical “January Effect” well into March and a successful Puerto Rico bond sale which may have staved off a possible debt restructuring for the time being. In spite of these unsettling events, the bond markets surprised many as yields, for the most part, continued to grind lower.

The annexation of Crimea from the Ukraine has become a concern for global markets. While the vote to break away from the Ukraine has been ratified by Russia, the West views this move as illegal and has issued sanctions in response. Russia, in retaliation to the sanctions, has begun diverting oil and natural gas exports away from Europe while increasing its exports to China. This move may increase energy costs for Europe as it forces them to rely more on distant suppliers such as the United States and the Middle East. Further intensifying the issue is that other areas may follow Crimea’s path. The potential for continued changes to the region’s geographical layout and political tough talk will continue.

The “January Effect” in the municipal market, where yields tend to decline, results from a lack of supply combined with an increase in demand due to the high amount of January coupon income and bond maturities. In 2014 this “effect” has lingered on for nearly the entire quarter. Even with the $3.5 billion dollar Puerto Rico deal, March’s issuance was still more than 12 percent below 2013 levels. Part of this downward trend is due to the lack of refunding deals. As rates remained suppressed throughout 2012 and 2013, many municipal issuers have already taken advantage of low interest rates to refinance their debt. To illustrate this point, on a year over year basis, refunding deals are down more than 40 percent.

One of the more anticipated events was the early March $3.5 billion Puerto Rico bond issue sold to extend the Commonwealth’s maturities and to shore up its liquidity. The bonds were well received as the deal was five times oversubscribed. Historically the municipal market is supported by retail investors but, in this case, a new customer base of hedge and distressed debt funds took more of a primary role in supporting the transaction. This ravenous appetite caused a frenzy as large blocks traded pushing the price up significantly in the days after the bonds hit the secondary market. Within two weeks, however, the bonds retrenched to trading back near original offering levels.

Domestically the economic news continues to show signs of improvement but at a muted pace. Much of the slowing growth in terms of overall employment and housing has been blamed on the unforgiving winter, and recent numbers seem to support that claim. The unemployment rate remains at 6.7% while labor participation is up a bit to 63.2%. Additionally, continued improvement in the underemployment number shows consistent, although small, declines the past 18 months. Continuing claims seems to be range bound while private payrolls have reflected growth the past four months. Other positives reflect household spending and fixed business investment continuing to rise. The Fed took advantage of the improving economic data as yet another opportunity to further reduce their buying mandate by another $10 billion ($5 billion in Treasuries and $5 billion in Mortgages). This third reduction brings the amount of Fed's monthly buying mandate to $55 billion from an initial level of $85 billion. If this rate of paring down continues, quantitative easing will be terminated prior to year end.

As investors continue to stretch for yield this demand has been found in maturities ten years and greater where the curve remains steep. Municipal rates reflected this activity as rates 10 years and greater declined by 7 to 29 basis points. The shorter end of the municipal yield curve showed strength in the 5 to 7 year range as well, but to a lesser degree. Municipals in the 1 to 4 year range were mixed with minimal movement. In comparison, US Treasuries outperformed their municipal counterparts in the 7 to 30 year range showing gains of 16 to 41 basis points, while underperforming in most of the short term maturities.

US Treasury Yields			
	12/31/2013	3/31/2014	Change
1 Year	0.14	0.10	-4 bps
3 Year	0.80	0.91	11 bps
5 Year	1.76	1.75	-1 bps
10 Year	3.11	2.76	-35 bps
20 Year	3.76	3.41	-35 bps

AAA Municipal Yields			
	12/31/2013	3/31/2014	Change
1 Year	0.15	0.17	2 bps
3 Year	0.55	0.54	-1 bp
5 Year	1.35	1.25	-10 bps
10 Year	2.94	2.87	-7 bps
20 Year	4.35	4.06	-29 bps

From a newer, yet seemingly temporary investor base, a prolonged period of limited supply and geographical remarking, the bond markets continued to show resiliency yet echoed the need for constant vigilance. As always we will remain diligent in monitoring these and new developments as we strive to provide solutions to meet our client's investment goals.