Quarterly Commentary 1st Quarter 2015: A Greek Drama

There is a famous Greek saying, which roughly translated, reads "Not even the gods fight necessity". This is a fairly good summation of where the Greek government stands in its negotiations with the IMF and their other creditors.

The concern of a Greek default has received a temporary reprieve as the country's finance minister has made the April debt payment owed to the International Monetary Fund. Leading up to this payment, negotiations with other EU member nations had not gone well. It almost seemed as a far gone conclusion that Greece would be unable to meet this payment. The funds were obtained from extracting liquidity from quasi state entities. While this is a temporary reprieve, additional payments will soon be due and the threat of default will once again be back on the table. The next date of significance will be April 24th when the Eurozone finance members are scheduled to meet. In the near term the new left-wing government will need to show resolve and be decisive in its actions. If it doesn't there may just be a Greek tragedy ahead.

Oil continues to be a story worth watching as the commodity declined another 13% during the first quarter of the year. Going forward, the potential for the commodity price to remain suppressed is uncertain. According to the most recent US Energy Information Administration report, slowing domestic production is anticipated while global demand is expected to increase. This news comes at an inopportune time as crude inventories are nearing capacity and may force some selling as drillers look to recoup some of their expenses. The tentative nuclear pack (which still needs final acceptance prior to the June 30th deadline) could further complicate matters. Iran, once the 5th largest producer of oil, could reemerge as a player in the market if trade sanctions are lifted as part of the nuclear agreement. The belief is that Iran could produce up to 700k barrels of crude a day by the end of 2016. Additionally, Iran is believed to have a fair amount of crude in storage and once the sanctions are lifted these reserves could be released to the open market adding to a fairly saturated market.

Domestically 4th quarter GDP figures reflected growth of 2.2% down from 5.0% in the previous quarter. The main driver of growth was an uptick in consumer spending, most notably in healthcare. The quarter over quarter contraction was due in part to a reduction in government spending, primarily in the defense sector. In addition, the continued bull run of the US dollar lead to an uptick in imports which also detracted from GDP. Personal Income continued its stretch of increases expanding by 0.4% during the first quarter of 2015. While the trend is positive, it remains barely ahead of inflation thus leading to minimal increases in personal consumption. Corporate profits declined 1.4% in the fourth quarter concluding a year in which annual profits declined 0.8% during 2014, a contraction after rising 4.2% a year earlier. These signs continue to point to a fragile domestic economy. As a result, the Fed's rhetoric regarding raising rates has softened.

On the municipal front, Puerto Rico continues to add concern. Public discussions surrounding consolidated debt restructurings were met with a backlash as Moodys was quick to condemn these talks, citing them as being "credit negative". Concerns regarding Puerto Rico's institutions have spilled over to other Puerto Rican municipalities, half of which are running negative general fund balances. The problem is systemic and the possible solutions to avoiding bankruptcy are quickly drying up.

During 2014 the municipal market benefitted from a supply/demand imbalance. Heading into 2015, the expected January effect of lower supply once again took hold. This was, of course, not unexpected. As we stated in our last piece, issuance for the New Year was expected to pick up in order to meet infrastructure demands and to refund higher yielding existing debt. As anticipated, on a year over year basis, issuance is up over 60%. While the uptick in issuance had the potential to widen spreads, the market response was muted. This, we believe, was due to the abundant amount of investable money which remained uninvested from January maturities, income payments and in municipal bond fund flows, which have been positive for fifteen consecutive months.

For the quarter, US Treasuries outperformed their municipal counterparts. For US Treasuries, yields declined all along the interest rate curve with the most pronounced movement in three to ten year maturities. Higher rated municipal credits also saw modest gains over the course of the quarter. AA rated credits showed consistent yield tightening across the yield curve versus AAA rated credits, with pronounced tightening specifically targeted in the five to ten year range. Single A rated municipals didn't fair quite as well and actually had yield widening in ten year maturities. With the bull-run in US Treasuries, historical ratios have been exceeded in the two to seven year range and ratios in excess of 100% are once again available in maturities ten years and longer.

US Treasury Yields			
	12/31/2014	3/31/2015	Change
1 Year	0.25	0.25	N/C
3 Year	1.15	0.94	-21 bps
5 Year	1.67	1.40	-27 bps
10 Year	2.22	1.98	-24 bps
20 Year	2.54	2.39	-15 bps

AAA Municipal Yields			
	12/31/2014	3/31/2015	Change
1 Year	0.27	0.25	-2 bps
3 Year	0.87	0.82	-5 bps
5 Year	1.38	1.30	-8 bps
10 Year	2.11	2.00	-11 bps
20 Year	2.69	2.67	-2 bps

While Greece and Puerto Rico seem to be headed towards a somewhat tragic, yet not surprising outcomes, the bond markets continue to steam ahead. The early stages of 2015 have shown a role reversal from last year as economic readings seem to reflect a domestic economy still trying to gain a firm foothold. The Fed continues to choose its words wisely, trying not to knock the train off the tracks. Oil's picture still seems murky at best. In the near term, the consumer stands to be the biggest beneficiary. Meanwhile, a robust demand is finally being satiated by an uptick in issuance of tax-exempt bonds, which has helped support the market. We will continue to watch the next act to side-step the dramatic tales that sometimes can end in tragedy.