Quarterly Commentary: The Great Taper Debate

The municipal market continued its rally early into the second quarter but a substantial reversal occurred when Ben Bernanke made comments suggesting that quantitative easing would begin to taper later this year and end in mid 2014. Market participants took this as the red flag that the bull market for bonds would end and started running for the exits. In the month of June alone, municipal yields increased 61, 80, 80, and 80 basis points respectfully in the 5, 10, 15 and 30 year AAA municipal maturities. Bond funds and ETFs saw their largest outflows in nearly five years wiping out nearly all their 2013 inflows. The sell-off had enough teeth that Ben Bernanke tried to downplay his statements and Bill Dudley, the President of the Federal Reserve Bank of NY, reaffirmed the sentiment that any reduction to the bond buying mandate is dependent not on calendar dates but on economic outlook. The attempt at damage control to calm the markets was to no avail. As a result, the Bank of England and the European Central Bank, watching the reaction and feeling the impact in their own markets, made it a point to reaffirm their stance of "accommodative fiscal policy" for the foreseeable future. It seems we're all friends until someone utters something that makes the rest of the room gasp.

Taken at face value perhaps Ben Bernanke's comments weren't an immediate prognostication but a hint to the market that the days of cheap money are coming to a close. The market reaction was a bit of a surprise. The question for the Fed isn't whether to taper or not to taper, but when. While we certainly agree that the economy is showing signs of life, it will need to start to function on its own at some point. That being said, the economy may not be quite ready to kick the crutches out from under it just yet. A closer examination of some economic data would explain why:

- The ISM manufacturing index in June showed an increase above 50, which is indicative of expansion. However, May numbers reflected just the opposite. Even with the improved June numbers, manufacturing employment contracted almost 1.5 percent during the month.
- While auto sales have been solid and mainly in line with expectations, retail sales less autos have shown two months of negative month over month growth.
- Wholesale inventories have been sporadic at best over the first six months of the year.
- The housing market has been stronger during 2013, with prices in major cities increasing more than 10% in some areas. Some of this can be attributed to low mortgage rates increasing sales. As interest rates increase, the amount of home sales may tend to tail off.
- Housing start numbers have fallen off since a spike in March of this year, which was attributed to rebuilding efforts in the wake of Superstorm Sandy.
- The unemployment rate has shown little change since February, while the underemployment rate continues to hover around the 14 percent mark.
- Personal income declined on average 1.2 percent during the first quarter of the year.
- Personal savings have increased throughout 2013, but still remain nearly two percent below pre-recession levels.
- Issues overseas continue. From China's credit problems to Japan's upcoming structural reforms, the resurgence of economic turmoil in Portugal and Greece and the uncertainty in Egypt will be a drag on exports.

- Exports are down 1.5 percent on a year over year basis. Continued sluggishness will prove to be a headwind against GDP growth.
- The sequester cuts will continue to cap government spending thus reducing GDP.
- On a positive note the US deficit is projected to be reduced to between $500 and $600 billion from the prior year's level in excess of $1 trillion.

Over the quarter, municipal rates increased across the curve as concerns the Fed may begin to wind down their quantitative easing mandate sent waves through the bond market. Municipal yields widened most on the long end with AAA municipal bond yields increasing by approximately 90 bps on 15, 25 and 30 year paper. The short end fared a bit better with yields increasing 23, 45 and 66 bps respectfully on 2, 3 and 5 year bonds. Treasury rates suffered a similar fate as municipal yields, albeit to a lesser degree. Municipal yields remain enticing to crossover buyers as ratios to Treasuries continue to maintain ratios in excess of 100% across the entire yield curve.

US Treasury Yields			
	03/28/2013	06/28/2013	Change
1 Year	0.12	0.17	5 bps
3 Year	0.38	0.68	30 bps
5 Year	0.79	1.40	61 bps
10 Year	1.92	2.52	60 bps
20 Year	2.82	3.31	49 bps
AAA Municipal Yields			
	03/28/2013	06/28/2013	Change
1 Year	0.18	0.19	1 bp
3 Year	0.48	0.93	45 bps
5 Year	0.90	1.56	66 bps
10 Year	2.12	2.95	83 bps
20 Year	3.14	4.02	88 bps

Overall the municipal market was strong during the beginning of the quarter posting another strong month in April but the remainder of the quarter reflected uneasiness and the tipping point was Ben Bernanke's comments which sent the market into turmoil. Rates climbed and the bond market sold-off. In the final week of the quarter, investors pulled $4.5 billion from municipal bond funds, the most since 1992 according to Lipper. Where this scared off some investors it provided a buying opportunity for others.

It is difficult to tell if we have reached an inflection point in the direction of interest rates. This is the third time since 2009 that we have seen a significant shift toward higher rates. In early

2009 and early 2011 the ten year US Treasury rose to around 3.75% from 2% levels and now we are seeing a 2.52% on the ten year Treasury up from the 1.90% area. The market's concern that the Fed's bond purchase program could be peeled back prompted this sell-off. To keep yields rising, we will need to see more economic growth. David Malpass, author of Encima Global Insights, mentions increasing loan demand, with commercial and industrial loan demand up 8.2%, as a potential source of incipient growth. Admittedly, economic hurdles still loom especially those embedded in a sticky job growth environment. It is no dark secret that we need more jobs to get personal income, saving and spending up, and which in turn will work to reduce government transfer payments. Surprisingly, the Federal deficit forecast has been brought down significantly due to higher tax revenues from earlier recognition of income and capital gains to beat the 2013 rise in tax rates and some lower expenditures as a result of the sequester cuts. It would be nice if we could keep the deficit in the half billion range, which implies a cut in US Treasury sales of $50 billion a month from last year's pace – a dreamy proposition which would partially offset the Fed's tapering prospects. Inflation, the real arch enemy for bond investors, seems to remain dormant as demand in the economy has been low. As always, we will be monitoring these developments as to how they can impact the bond market in conjunction with searching for bond investment opportunities to enhance our clients' portfolios.