Quarterly Commentary- Q2 2014: Good News, Bad News

Finding the silver lining sometimes can be challenging. During the second quarter some good and some distressing news was bestowed upon the markets.

The State of California was recently upgraded by Moody's, its highest rating since May of 2001. California, with its large and diverse economy, is typically a bellwether for the US economy. As it improves, typically the country's economy is not far behind. Additional positive news was, and continues to be, found in terms of fund flows. Municipal fund flows have remained positive for the year, with the largest flows recorded in May. This, in combination with issuance reflecting the second lowest year to date figures in 13 years, has provided support for the market. While we anticipate the issuance trend to continue, June showed a reversal as refundings increased significantly on a year over year basis. If rates continue to remain range bound, there is the potential to see an uptick in refundings during the second half of the year. Even with the possibility of increased issuance to retire existing debt, target issuance for the year is still projected to be down 20-30% from last year. This supply demand imbalance will provide continue strength for the municipal market.

The situation in Puerto Rico continues to evolve. The passage of recent legislation allows public corporations, such as the Puerto Rico Electric Power Authority and the Puerto Rico Aqueduct and Sewer Authority, to restructure their debts. The rationale behind this decision was to separate the Commonwealth from public entities that continue to face financial difficulties. The intended goal was to remove the dependence on the central government as a backstop for fiscally ailing entities and, in doing so, provide some financial relief for the government. The ratings agencies viewed this action, which provides little protection for bondholders, as a potential preview for restructurings of the general obligations of the Commonwealth and led to cutting ratings dramatically. Bonds of Puerto Rico, in response, traded cheaper even though the impact on the overall market was minimal. Any forced selling of other municipal securities by municipal mutual funds may present a possible buying opportunity.

Domestically there has been a mixed bag of economic news. GDP for the first quarter was -2.9% annualized. Much of this number has been blamed on the harsh winter. Not withstanding the reason, GDP will have to grow substantially in order for economists' projections of 3 to 4% growth for 2014 to be realized. Non-farm payroll numbers showed fairly strong growth during the second quarter with April and June numbers reflecting nearly 300k jobs created. However, a closer investigation into the numbers reflect that a large portion of the jobs created were part time. This, in part, leads to an underemployment number that remains in the double digits and a labor force participation rate hovering at its lowest level in more than thirty years. While the unemployment rate has fallen to its lowest rate since September of 2008, indications are that more individuals are having difficulty finding targeted full time employment. The Fed has continued the reduction of its bond buying mandate and, as written about last quarter, at this rate quantitative easing will conclude prior to year end. Once QE ends, the true strength of the US economy, without the support of the bond buying mandate, will begin to be realized.

From a mounting debt load that continues to overshadow recovery in nations such as Portugal, Greece, Spain, Italy and Japan, to increasing tensions in Israel and continued aggression and atrocities in Iraq, internationally things continue to worsen. In response, investors have implemented a flight to quality trade, including commodity buying such as oil. Since the ISIS offensive in Iraq began in mid June, crude prices jumped nearly four dollars a barrel and it maintained that price for the next few weeks. As Iraqi troops regained a bit of control back, including recapturing the oil hub of Kirkuk, crude prices stabilized and even more recently have begun to decline as Iraqi supplies are no longer in immediate peril, and Libyan oil exports are expected to increase. This instability and the potential for continued geo-political disruptions could cause crude prices to become inflated again, which could potentially be a drag on the economies of oil dependant nations. Additionally, high debt burdens in the Eurozone as well as reports of an economic slowdown in China and Germany illustrate that the hangover from the Great Recession may not be over yet.

The bond market continued to grind toward higher prices, thus lower yields, with municipals and Treasuries performing well during the quarter. For US Treasuries, bond prices reflected increases in the 3 to 30 year part of the curve with the most pronounced movement in bonds maturing 5 years and longer. Municipals also reflected strength in the 7 to 30 year part of curve with rates decreasing in excess of 70 basis points in bonds maturing 15 years and longer. The risk trade of buying bonds lower in quality had relatively little impact outside of bonds maturing 5 years and in. Longer bonds saw higher rated credits outperform their lower rated counterparts. While ratios of US Treasury to municipal yields has trended downward to historical norms in the 2 to 7 year range, relative value can still be found in the 10 to 30 year range.

US Treasury Yields			
	3/31/2014	6/30/2014	Change
1 Year	0.10	0.14	4 bps
3 Year	0.91	0.90	-1 bps
5 Year	1.75	1.63	-12 bps
10 Year	2.76	2.57	-19 bps
20 Year	3.41	3.17	-24 bps
AAA Municipal Yields			
	3/31/2014	6/30/2014	Change
1 Year	0.17	0.15	-2 bps
3 Year	0.54	0.63	9 bps
5 Year	1.25	1.24	-1 bp
10 Year	2.87	2.33	-54 bps
20 Year	4.06	3.26	-80 bps

From an economic recovery that continues to sputter, geo-political unrest and Puerto Rico's troubles, it would be easy to see the glass as half empty; however, municipal cash flows are generally positive. The municipal market continues to show gains as issuance remains on track to be approximately 20 to 30% below last year's total, and municipalities continue to show signs of economic growth. These forces, both positive and negative, should provide support and opportunities for the fixed income market. The ability to navigate through unrest and uncertainty speaks to the importance of maintaining active management. We will continue to provide the diligence and guidance to generate solutions to meet our client's investment goals.