Quarterly Commentary: Coastal Depression

Debt issues aside, Greece and Puerto Rico have something else in common- shorelines. Greece has the eleventh longest coastline in the world, while Puerto Rico- even though a US territory- still boasts the 94th longest coastline in the World. Along with beaches and frolicking in the sun, storms remind us of the power outside forces can impart on said shorelines. The debt conundrum facing both issuers has caused dark clouds to form overhead. A storm is imminent.

During our last quarterly commentary, Greece was able to ward off a default by making an April debt payment to the International Monetary Fund. Since then, the situation has only deteriorated. Members of the EU have questioned Greece's resolve and trust worthiness as the Syrizan government urged the public to vote down a referendum- which, ultimately, they did. More recently, the Greek Prime Minister agreed to a new set of austerity measures which would merely open the door for negotiations to unlock further bailout funds. The agreement is causing a rift that is quickly developing among the Prime Minister and his Syrizan government colleagues. The agreement did, however provide Greece with a bridge loan, allowing the country to get current on payments owed to the IMF. Additional bailout or not, the debt per captia has exceeded overall earnings for Greek citizens. Deal or not, a default is seeming like an inevitable fate.

Puerto Rico once again has captured the bulk of the headlines when, in late June, Governor Alejandro Garcia Padilla stated that the island's debt burden was "unpayable". Part of this is an unsustainable cycle in which the Commonwealth believed continued expansion would be the catalyst enabling the repayment of debt. The reverse has happened and the economy has shrunk instead. The economic contraction is nothing new for the island nation as tax incentives, which began expiring in the 1990s, combined with the 2008-09 recession amplified the downward spiral. Further exacerbating the issue is the rate at which citizens have been leaving for the US mainland- approximately 50,000 each year- thus depressing tax collections even further. For Puerto Rico, access to the capital markets is of vital importance and the loss of investor confidence has only increased debt expense as the Commonwealth has been forced to offer above market rates of return to get the financing they need. Legislators are pushing for a governance change which would give Puerto Rico the ability to file for bankruptcy, which would then provide the capacity to restructure their debts.

Besides Greece and Puerto Rico, other international headwinds exist as well. The Chinese stock markets have been in a freefall over the past few weeks. Since hitting record highs in mid-June, the Chinese stock markets have fallen 30% and, if not for government intervention, could have fallen further. The Chinese government has enacted the following to slow the sell-off: banning executives and big shareholders from being able to sell securities, a short term moratorium on bringing IPOs to market, ordering the broker dealer community to buy securities, banning short selling and relaxed margin trading rules. The market cooling has quelled the government's talks for swapping debt to equity in order to slow China's mounting debt to GDP ratio, which has grown rapidly since 2008. While there are differing thoughts on what happens when the artificial measures are removed, Chinese markets remain volatile, although a level of stability has been regained.

Domestically, the third revision of first quarter GDP decreased at an annual rate of 0.2 percent. This revision is an improvement from the previous estimate which indicated a decrease at an annualized rate of 0.7 percent. The overall decrease in Q1 GDP reflected an increase in imports and negative contributions from exports and lower spending on the state and local government levels. In spite of this, the Fed continues their language suggesting an interest rate hike this year, assuming forecasts for stronger growth and lower unemployment are realized. While a housing boom continues, wages remain stagnant and retail sales continue to be sticky. Oil has had a resurgence of late hitting a six month high in May. However, high levels of production and an Iranian nuclear deal should provide an abundance of supply, which has the potential to drive prices back down. A savings at the pump is positive for business, but if consumers take their savings and use it to repay debt instead of purchasing consumables, as they did with the previous gasoline savings, the US economy can look forward to more lackluster GDP growth.

The global turmoil caused a fair amount of pressure on both equity and bond markets. Taxable and municipal bonds showed yield increases in maturities all along the interest rate curve with the most pronounced movements in maturities seven years and longer. In spite of the back-up in rates, municipals fared slightly better than their taxable counterparts. Additionally, the credit quality trade was back on as AAA rated municipals outperformed lower rated credits. Municipal to US Treasury ratios retrenched a bit from the end of the previous quarter, but remain above their historical norms, thus providing relative value.

US Treasury Yields			
	3/31/2015	6/30/2015	Change
1 Year	0.25	0.28	3 bps
3 Year	0.94	1.08	14 bps
5 Year	1.40	1.67	27 bps
10 Year	1.98	2.42	44 bps
20 Year	2.39	2.94	55 bps

AAA Municipal Yields			
	3/31/2015	6/30/2015	Change
1 Year	0.25	0.32	7 bps
3 Year	0.82	1.01	19 bps
5 Year	1.30	1.45	15 bps
10 Year	2.00	2.37	37 bps
20 Year	2.67	3.10	43 bps

Coastal locations are picturesque, but can also be dangerous when changing climates bring about storms. Greece and Puerto Rico have clouds overhead and the impending storms have the potential to bring about challenging conditions. It spite of this potential, municipals continue to navigate the headwinds and outperform their counterparts while providing relative value.