

Quarterly Commentary 3rd Quarter 2014: Halloween Comes Early

It appears as though our calendar is wrong. The time of year of watching horror movies and dressing up in costume seems to have arrived earlier than usual. World headlines have provided a grim landscape. Alas, treats exist within the news as well.

In spite of world developments that make watching the news cringe worthy, the municipal market continues its bull run. Municipal fund flows, which have provided for the supply-demand imbalance in place for most of the year, continue to be positive, albeit at a more modest pace. Early in the year the hang-over from a lasting January Effect helped to support rates as municipal issuance was trending 20% below 2013 levels. This gap has narrowed to approximately 14% as there has been a recent uptick in new issues. Following a consistent pattern from 2013, the 3rd quarter provided 2 of the top 3 months in terms of overall yearly issuance. While we believe that the uptick in issuance will continue through year end the amount should be dwarfed by 2013 figures. At the end of last year, municipal issuers pushed 2014 deals into December 2013 in fear of the possibility that the municipal tax-exemption may be altered. This was a somewhat debated topic in Congress at that time (these discussions have since dwindled). Without any incentive to push up deals, the expectation for a robust fourth quarter of issuance seems less likely. With fund flows continuing their positive momentum, maturities and coupon payments outpacing new issuance and a fair amount of cash sitting on the sidelines, continued support for municipal price levels seems likely.

Internationally, the world continues to resemble something out of a horror movie. From Middle East flare-ups, US military involvement in the form of air strikes in the region, anti-government protests in Hong Kong, Ebola and underwhelming growth prospects coming out of the Euro zone; it's enough to make one cover their eyes. ISIS's selling of oil on the black market combined with US domestic supply reducing foreign dependency and Saudi Arabia's reluctance to curb production has caused the price of crude to fall approximately eight percent since the end of June. For large exporters of oil (Russia, China), this dramatic fall in the price of oil could negatively impact the economies of these nations. Additionally, Germany is on the brink of a recession as exports to China and Russia, their main trading partners, have fallen sharply. Germany's July industrial production numbers fell by 4 percent, which is the largest month over month drop-off in five years. The IMF recently cut its global growth outlook in 2015 from 4% to 3.8%, citing deteriorating outlooks for the euro area as well as Brazil, Russia and Japan.

Domestically, metrics are showing strength. The domestic economy is predicted to grow at a rate of 2.2%, which is up from predicted levels of 1.7% in July. 2015 projections have also been increased from a 3.0% reading in July to 3.1% according to the IMF. While growth is seen to be on an uptick, accommodative policy is still seen as being appropriate, considering inflationary risks at this stage are minimal. Expectations are that the Fed's buying mandate should conclude in October; and that the Fed Funds rate may see its first increase in early 2015. On the jobs front, private and non-farm payroll numbers continue to trend positively, pushing the unemployment and underemployment rates to their lowest levels since 2008. Hourly wages have not, unfortunately, kept pace with employment, which has led to suppressed personal spending. While the US dollar gains momentum versus the Euro and Yen, a slowing global economy may be a drag on continued growth.

Municipals continued their bull run during the 3rd quarter, again outpacing US Treasuries. Yield compression occurred in maturities five years and longer, with the most pronounced movement in bonds maturing in 15 years or more. In the same maturity range, AAA municipals proved to be the best performer, thus making a lower quality bet irrelevant. The reverse was true in the 3 to 10

year range as single A rated municipals outpaced their AAA rated counterparts. US Treasury to municipal ratios have continued their downward trend, even dipping below historical norms in the 2 to 5 year maturity range. Bonds expiring in seven years or more continue to provide cross-over buying opportunities.

US Treasury Yields			
	6/30/2014	9/30/2014	Change
1 Year	0.14	0.14	Flat
3 Year	0.90	1.14	24 bps
5 Year	1.63	1.81	18 bps
10 Year	2.57	2.56	-1 bps
20 Year	3.17	3.04	-13 bps

AAA Municipal Yields			
	6/30/2014	9/30/2014	Change
1 Year	0.15	0.16	1 bp
3 Year	0.63	0.65	2 bps
5 Year	1.24	1.23	-1 bp
10 Year	2.33	2.23	-10 bps
20 Year	3.26	2.93	-33 bps

While one doesn't need to dust off the costumes just yet, it appears as if Halloween may have come a bit early. Even though there is a high level of uncertainty in both the bond and stock markets, the US economy is showing signs of strength. Coupled with a strengthening US dollar, the United States may be the princess in a room full of zombies. Geo-political unrest, elevated tension in the Gulf region, Ebola and downward revisions to Euro zone growth prospects can make investors wary of walking down the dark alley of investing alone. Having a skilled investment manager assist in navigating the uncertain times is important. We will monitor events as they unfold and continue to provide necessary oversight to keep the monsters at bay.