Quarterly Commentary- Q4 2013- The News That Wasn't Yet Could Be

The final quarter of 2013 had a few storylines that left the audience far from the edge of their seats. The two major events of the quarter were the start of the end of quantitative easing and the court's ruling in the Detroit bankruptcy case, which not only allowed the Chapter 9 filing to proceed, but also set a precedent which no longer protected public employee pensions. These news items were either priced into the market or have a story long since told as the market perceived these events as much to do about nothing. Some stories though may not be as well anticipated.

The ''when'' component of the great taper debate has become a debate no longer. The Fed finally made the decision to begin easing their purchasing mandate with a $10 billion dollar reduction ($5 billion in Treasuries and $5 billion in Mortgages). The days of cheap money are beginning to see their twilight. The expectation and rhetoric from the Fed is that quantitative easing will end at some point during 2014. The Fed will maintain an accommodative policy for the foreseeable future. While this was not unexpected news, the timing may have been expedited a bit thanks in part to stronger than expected payroll figures in October and the durable goods number in November. Bond markets had minimal movement in response to the initial phase of the reduction, having anticipated it for some time. From the date of the announcement, December 18th, through that week ending December 20th, the largest yield move in municipals was in the ten year range where yields moved up 6 basis points. The pace at which tapering continues could cause some ripples if done so at a rate which hinders growth.

Also in the news was the Federal ruling regarding Detroit's Chapter 9 bankruptcy filing. On December 3rd the court ruled that Detroit is eligible for bankruptcy and that retiree pensions can legally be reduced during the Chapter 9 restructuring process. It was also stated that the City did not provide ample time or resources to bargain in good faith, but it also observed that having in excess of 100,000 creditors, including many of whom were unwilling to negotiate, made it impracticable to do so. Although no one was certain how the court would ultimately rule, it was hard to not heed the fiscal stress Detroit has been under for many years, thanks in part to fiscal mismanagement and fraud. The market's response to the ruling was muted at best. In the three days after the decision, the largest movement was a four basis point increase in yields in the seven to thirty year range. That said, the potential long term repercussions of the pension decision could have a more profound impact on the municipal market.

The declaration by US Bankruptcy Judge Steven Rhodes that pensions can be cut, even in those states that have them protected by State Constitutions (Detroit for example), is a landmark decision, and after the appeals process, may eventually find its way to the Supreme Court. If pensions are allowed to be adjusted, this may provide a framework for other fiscally distressed cities such as Philadelphia, PA and Compton, CA.

Puerto Rico continues to confound. The government has been relentlessly holding webcasts and investor meetings with the aim of calming investors' nerves. As things deteriorate further, there is the chance that it all may be coming to a head. Entitlements and transfer payments from the mainland make up nearly 40 percent of Puerto Rico's personal income, according to Forbes. Additionally, unemployment is consistently in the 14 percent range, while the labor participation rate is 41 percent. This is an alarming figure when compared to mainland levels which are currently at 63 percent. The Commonwealth is coming to market in the near future with the aim of avoiding a possible downgrade as the rating agencies have voiced concerns that Puerto Rico may be unable to access capital markets.

Overseas the story in China continues to reflect GDP worship. Even though auditing of local borrowing found sizeable increases, rapid loan growth shows little signs of slowing. On a year over year basis (through the 3rd quarter), there has been a 14 percent increase in loan generation. The continued borrowing has not translated into an equivalent increase in GDP growth. This may force the Chinese government to tighten loan growth which may be a drag on growth. GDP estimates of 2014 growth are 7.5 percent, which was the same target as 2013.

Domestically the news has been somewhat stronger. As the taper debate has raged on markets priced in the expectation of a reduction in the Fed buying mandate, and we saw limited movement in yields in response to the actual reduction. Positive economic data in payroll and durable good numbers expedited this move. Revised third quarter GDP was 4.1 percent. Just over 40 percent of the increase was due to inventory building, which could be the result of lackluster holiday sales. As inventory levels are worked down, this could point to potential slower growth in 2014. With the appointment of the new Fed Chair Janet Yellen, the pace of the end of quantitative easing will be interesting to watch as many believe that the new Fed Chair is more conservative than her predecessor in regards to removing any market support. The upcoming debt ceiling debate will be the next pause for concern. While encouragement can be found that a budget deal got completed before the eleventh hour, the chance for political wrangling can't be underestimated.

As the equity markets continued their rally, municipals outperformed US Treasuries despite continued outflows from municipal bond funds. In municipals, the short end of the yield curve continued to show strength as investors, concerned about rising interest rates, dug in their heels. As a result, the one to five year range saw yields go lower by five to fourteen basis points, with the three and four year range performing the best. The remainder of the yield curve saw increases in yields with the 20 to 30 year range off fifteen basis points. For lower rated municipal credits, investors gained less on the short end of the yield curve as compared to their AAA rated counterparts. For maturities seven years and longer, lower rated credits outperformed higher rated credits only showing minimal yield increases on bonds 20 years or longer. In contrast, Treasuries were weaker across the yield curve with yields increasing the most in the five to fifteen year range. With the underperformance of the Treasury market, municipal to Treasury ratios have narrowed across the yield curve and have returned to historical levels in the three to five year range. The one to two and seven to thirty year ranges continue to offer relative value as their ratios continue to trend above historical levels.

US Treasury Yields			
	09/30/2013	12/31/2013	Change
1 Year	0.11	0.14	3 bps
3 Year	0.63	0.80	17 bps
5 Year	1.39	1.76	37 bps
10 Year	2.67	3.11	44 bps
20 Year	3.46	3.76	30 bps

AAA Municipal Yields			
	09/30/2013	12/31/2013	Change
1 Year	0.20	0.15	-5 bps
3 Year	0.69	0.55	-14 bps
5 Year	1.41	1.35	-6 bps
10 Year	2.84	2.94	10 bps
20 Year	4.20	4.35	15 bps

News can sometimes be expected, while at other times it can be the harbinger of events on the horizon. The fourth quarter certainly provided us with such an illustration. Market reaction dictated that the inception of tapering and the federal court ruling regarding Detroit's bankruptcy was expected news, and therefore reaction was minimal. Laying in the wings are the pace and eventual termination of quantitative easing, the appeals associated with Detroit's bankruptcy and the attempt at clawing back pension benefits, Puerto Rico's impending bond sale and the market reaction to it, and lest we not forget, the upcoming debt ceiling debate. These events can certainly provide turbulence in the municipal market, but a light calendar faced with investable funds should provide support for the market in the short term. We will remain diligent in monitoring these developments as we continue to search for issues that provide relative value for our clients.