Quarterly Commentary 4th Quarter 2014: Black Gold?

Since the US oil industry's inception in 1859, the commodity has commonly been referred to as "black gold", primarily because of its color and the riches that accompanied its discovery and production. If the current trend of falling oil prices continues, or a new price norm is established, a renaming may be in order.

Oil prices since the end of September 2014 have fallen by more than 50% thanks in part to reluctance on the part of OPEC to curb production and increased domestic production. Based on available data, the US has surpassed Saudi Arabia and Russia as the highest oil producing country. While this surge in production has helped the US recovery, the fall in oil prices has hurt large producing countries such as Saudi Arabia and Russia, which depend on oil exports to support their economies. For countries that import oil- China, Japan and India- the fall in oil prices should provide a springboard for economic growth. The refusal by OPEC to slow production, combined with the high costs of shale oil, has put a strain on domestic production resulting in lost investment and hiring within the sector. There is a possibility that oil prices may remain suppressed for some time, if not creating a new price norm altogether.

In the United States, metrics continue to show signs of growth. However, the data is a bit misleading. Revised third quarter GDP figures showed growth of 5.0%, while personal consumption rose 0.5% from October to November. The month over month increase was due to a large increase in durable goods and motor vehicle spending. While the positive personal consumption trend is welcome news, it may be unsustainable. For the average consumer, the decline in oil has translated into savings at the pump. The same can not be said for wage growth. According to the Labor Department, wages increased at 1.7% during the year, which is barely outpacing inflation. Jobs data for the year was also confounding. The largest jump in job growth since 1999 was seen in 2014 with the creation of 2.95 million jobs. The US economy added more than 200,000 jobs in every month except January, leading to a fall in the unemployment rate from 6.7% to 5.6%. These figures do not tell the whole story as the labor participation rate remains relatively unchanged and continues to hover around thirty year lows.

Overseas, foreign growth continues to contract; and calls for accommodative policy measures have caught favor. The slowing growth has begun spilling over into emerging market economies as well. Greece has fallen back into the abyss of economic turmoil while Russia seems to have no economic back-up plan to combat the tide of falling oil prices. Fears of a slowing global economy are weighing domestically on the prospects for continued growth. The US dollar continues its bull run versus its foreign counterparts, leading to heavy foreign investment in US debt. This investment support from the international community appears to have replaced some of the role vacated by the Fed as Quantitative Easing concluded.

Throughout the year we have talked about the supply/demand imbalance and the support for municipals it has provided. Early on in the year we saw a year over year gap that hovered around 15%, but over the last two quarters we've seen that gap shrink. The fourth quarter provided further narrowing as refundings paved the way for additional issuance to the tune of $22 billion on a year over year basis. In spite of the unexpected jump, issuance was down nearly 4% from 2013. The potential for this imbalance to continue into 2015 seems less likely. Back in 2005 issuance peaked and was among the highest in the then recent memory. The low rate environment, ample refunding opportunities and infrastructure needs should lead to an uptick in overall issuance for the year ahead.

All good things eventually come to an end and so did the municipal bull-run in the short end of the yield curve. Municipals reflected weakness in maturities five years and shorter while the party continued for bonds maturing in seven years or more. High quality issuance, again, ruled the day as lower rated municipals underperformed their higher rated counterparts. The most profound movements could be found in longer maturities thus compressing what has been a steep yield curve for a prolonged period of time. In comparison, US Treasury yields showed strength in maturities longer than four years. Again, the longer end of the maturity spectrum showed the greatest appreciation. In terms of overall ratios, maturities inside of four years have trended back to historical levels. Relative value still exists in longer maturities, even exceeding 100% of US Treasury yields on bonds maturing fifteen years and longer.

US Treasury Yields			
	9/30/2014	12/31/2014	Change
1 Year	0.14	0.25	11 bps
3 Year	1.14	1.15	1 bp
5 Year	1.81	1.67	-14 bps
10 Year	2.56	2.22	-34 bps
20 Year	3.04	2.54	-50 bps
AAA Municipal Yields			
	9/30/2014	12/31/2014	Change
1 Year	0.14	0.27	13 bp
3 Year	0.65	0.87	22 bps
5 Year	1.24	1.38	14 bp
10 Year	2.23	2.11	-12 bps
20 Year	2.91	2.69	-22 bps

For the year, the municipal market has been a tale of two cities, with the short end of the yield curve underperforming and the longer end having a banner year. The supply/demand imbalance played a large role in the outperformance as redemptions and refundings outpaced new issuance. The marketplace had its fair share of news this past year, most of which was credit positive, as state and local governments began to see tax collections return to pre-recessionary levels. Challenges still exist as the negotiated bankruptcy in Detroit, Puerto Rico's path pointing towards a negotiated bankruptcy, and pension fund liabilities create havoc for cities such as Chicago and its home state, Illinois. Diligence still rules the day. We wish you well for a happy and healthy 2015 and thank you for your continued support.