The Investor's Edge

C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING
IN TAX-EXEMPT MUNICIPAL SECURITIES

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Federal Reserve on the Move

Federal Reserve Chairwoman Yellen indicated late last year that three tightening moves could be in the monetary authorities' game plan this year following their two 25 basis point moves at the end of 2015 and mid-December last year. Given their relatively quick mid-March subsequent action that notched the targeted Fed Funds rate higher by another 25 basis points, Ms. Yellen's prediction must be given credence. Additional tightening moves from the current 0.75-1.00% target range will, as always, be dependent on the pace of economic growth, continued healthy labor reports and the inflation outlook. Minutes from the Fed's mid-March FOMC meeting indicated that members felt the economy is near full employment with the unemployment rate at 4.70% in February while the Personal Consumption Expenditures Price Index, the Fed's preferred inflation measure, has risen near their targeted 2.0% level. The March non-farm employment report indicated that the unemployment rate notched still lower to 4.5% despite a lower than forecast employment gain during the month.

The March FOMC meeting minutes also indicated that the Fed discussed shrinking their $4.5 trillion balance sheet. While immediate action is not contemplated, a slow unwinding of the Fed's holdings could begin later this year with proceeds from maturing mortgage backed securities not rolled into new investments. Absence of the Fed's substantial demand (i.e. reversing quantitative easing) would, in effect, produce additional tightening in conjunction with increases in the Federal Funds Rate.

Economic View

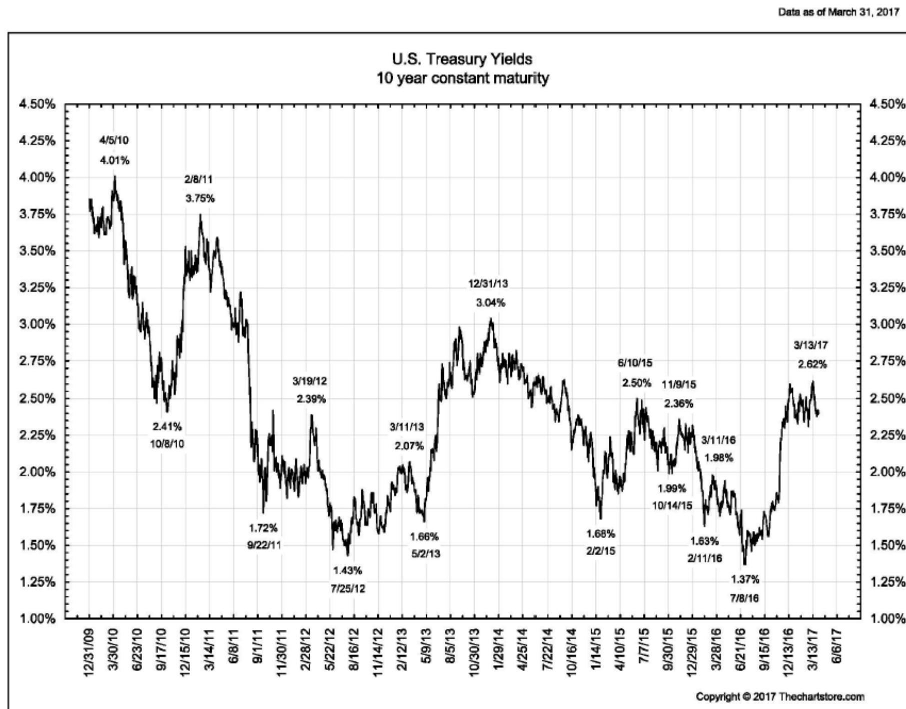
In addition to reforming The Affordable Health Care act and immigration, President Trump's stated agenda is focused on ramping RGDP growth higher by lowering taxes, eliminating burdensome regulation, bolstering defense spending, improving trade agreements and initiating a trillion dollar infrastructure improvement program. As evidenced by the inability of House Speaker Ryan to move the replacement health care act forward and the rancor over Judge Gorsuch's Supreme Court nomination, implementing the President's entire agenda will be challenging. We anticipate that consumer spending will remain reasonably vibrant as job growth continues to climb which should sustain moderate economic growth, but acceleration from the current 2+% pace of RGDP expansion over the intermediate horizon seems unlikely. In addition, tighter monetary conditions will have a moderating impact on interest sensitive sectors (e.g. housing) and create some headwind.

Inflation rates have crept higher in recent months but remain constrained. Depressed commodity prices and limited wage gains (+2.7% year-over-year through March) do not suggest that rapidly accelerating price pressures are likely.

Bond Market Action

In contrast to the post-election spurt in interest rates that drove the ten year Treasury yield from a 1.37% low last summer, interest rates have been relatively stable in the recent quarter. As shown in the

following chart, the ten year Treasury rate ranged between 2.30% and 2.62% since year end. Reduction or elimination of Federal Reserve bond purchases could pressure longer rates later in the year, but we expect that any moves by the Fed will be modest and well telegraphed in advance. Rates will likely remain range bound near term with upward pressure contained by continued strong demand for fixed income securities by domestic and foreign buyers. Low, and in some cases, negative rates in Europe and Japan due to on-going foreign central bank monetary stimulus enhance the attractiveness of U.S. fixed income investments.



Municipal Market

Municipal yields followed the Treasury market's lead during the quarter. Prime ten year tax-exempt yields remained in a relatively narrow 2.14% to 2.50% range and closed the period at 2.26%, essentially unchanged from year end. New issue municipal supply was modest during the quarter with volume totaling $89 billion, down from $100 billion in the first quarter of last year. Unless issuance picks up significantly, new financings are likely to significantly trail last year's $448 billion annual total. We are estimating about $370 billion in new issuance.

Strong investor demand for tax-exempt income in an environment of limited supply is expected to keep a lid on longer municipal yields. Baring a surge in economic growth or an inflation spurt, both of which appear unlikely, we expect that upward pressure on the long end of the yield curve will be modest. In contrast, short rates appear poised to move somewhat higher in response to Fed tightening and produce a flatter yield curve. The current spread between one and thirty year prime tax-exempt yields is about 215 basis points. A decline in the spread by 50 or more basis points would not be surprising.

C.W. Henderson's barbell structured portfolios tend to provide attractive relative performance in curve flattening environments. The short segments of the barbells typically account for 50-60% of a portfolio's

total assets. Two strategies are utilized in this account component: intermediate maturity high coupon bonds with six month or shorter calls and fifteen to eighteen month securities that roll down the short end of the yield curve. The effective duration of this portfolio component is typically eight to nine months which tempers the impact of rising short rates. High coupon short call bonds are purchased at market level yield-to-call prices. Corresponding yields to maturity on these bonds are typically 2-3% higher than the yields to call. Therefore, bonds that are not called provide significantly enhanced returns as the as they advance toward their maturities. The attractiveness of these securities is heightened as short rates rise since the incidence of calls declines. The fifteen to eighteen month bonds that comprise the remainder of the short portion of the barbells are generally sold when their maturities decline to a year or less. Sale proceeds are reinvested in higher yielding securities as short rates rise which also serves to cushion the impact of rising short rates.

The longer components of the barbell constructed portfolios are primarily invested in ten to fifteen year maturity bonds with nine or ten year call protection. These securities take advantage of higher yields provided by the typically steep yield curve. The overall portfolio structure provides a conservative risk/reward balance in keeping with the Firm's dual objectives of providing attractive levels of tax-exempt income and positive total returns. We have developed research papers that profile C.W. Henderson's performance in rising rate and Fed tightening environments which we would be pleased to provide.

Client portfolio durations were increased late last year from 3.4 to 3.8 years in response to the surge in rates in the fourth quarter. This positioning is approximately 8% below neutral and retains a degree of caution given the persistence of relatively low nominal rates.

Narrow Credit Spreads

Periods of reduced supply with strong demand, as is currently the case, result in lower yields and tighter credit spreads as investors who need to make commitments bid up prices on available merchandise. This condition has prevailed for some time and has become more pronounced in recent months. As an example, Minneapolis-St. Paul Metropolitan Airport issued new bonds in early December that were structured with a 5.0% coupon and mature January 1, 2031. The bonds are callable beginning July 1, 2027 at par. The credit has AA- ratings from S&P and Fitch. In our view this credit should provide 50 to 60 basis points of additional yield relative to the AAA scale. At issue the spread was a narrow 38 basis points and has subsequently tightened further to about 25 basis points. This low yield premium is comparable to the credit spread typically associated with sound AA general obligation credits.

Unless new issue volume rises significantly or credit concerns develop, it is likely that credit spreads will stay tight and possibly narrow even further. This creates a challenging environment in which to trade, but C.W. Henderson's small relative size ($3.2 billion of assets under management) works to our advantage. We have been able to purchase bonds with attractive structures that meet our credit standards without paying through the market. Our larger competitors do not have this luxury and are, at times, forced to purchase whatever bonds and prices are available to invest cash flows.

Emphasis on Credit Quality

As indicated above, limited supply has not caused us to lower credit standards and portfolios are structured, on average, with AA+ rated securities approved by the C.W. Henderson credit team.

Adherence to high credit standards coupled with portfolio duration management remain core components of our investment philosophy and process. Credit selection focuses on state and local general obligation, essential service revenue and strong higher education securities. Many credits with adequate Moody's, S&P or Fitch ratings have been rejected by our credit group due to declining financials, insufficient reserve levels, underfunded pension plans, inadequate post-employment health care funding, etc. A recent paper that discusses our review of various revenue bonds and provides insight into our process, "Essential Service Revenue Bonds: A Safe, Conservative Investment", can be found on our website.

Tax Reform

We discussed tax reform in our previous newsletter and suggested that passage of a bill was likely later this year. We continue to feel that tax reform will be enacted, but the odds appear a bit lower given legislative acrimony. Achieving meaningful tax reductions while mollifying special interests and achieving some semblance of revenue neutrality will be extremely challenging. However, tax reform is a central component of President Trump's aggressive agenda and will be pursued aggressively.

Lower corporate and personal tax rates will be a high priority which would decrease the attractiveness of tax exempt securities to some degree. However, with ten year prime municipal yields at about 92% of like maturity Treasury rates, much of this appears to be priced in the market. One remote possibility is the elimination of the tax exemption and "grand fathering" outstanding municipals while eliminating the tax exemption on future issuance. This is not reflected in current tax-exempt/taxable ratios. Any effort to sharply curtail tax exemption would be met with strong protests from state and local officials who would aggressively argue against any action that increases their cost of capital. We assign a low probability to this happening. Developments in the coming months will be closely monitored.

Firm News

We are pleased to announce that Ben Shirley has joined C.W. Henderson. A 2004 Indiana University graduate, Ben has extensive municipal trading, portfolio management and sales experience. He has joined the trading/portfolio management team adding expertise and depth that will further enhance the professionalism of our portfolio management process. Welcome aboard.

Craig W. Henderson | Thomas L. Mallman, CFA | Matt Andrews

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