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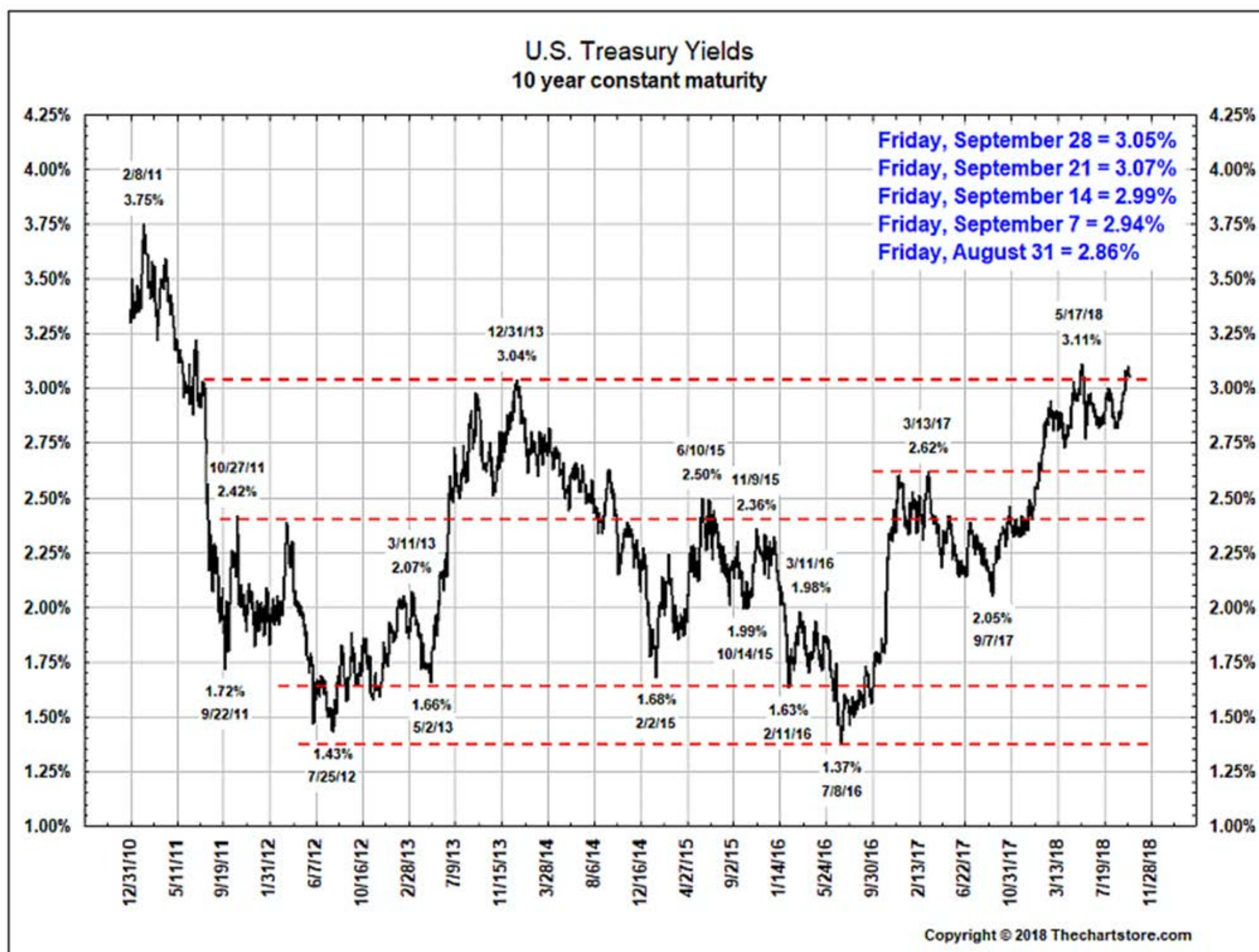
C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING
IN TAX-EXEMPT MUNICIPAL SECURITIES

The Investor's Edge

Interest Rate Outlook

The U.S. economy remains on an expansive path with RGDP forecast to exceed 3.0% this year with continued, although somewhat lower, growth in 2019. Low unemployment has bolstered consumer confidence and, in turn, spurred personal spending. Corporate earnings growth has been enhanced by the decline in the corporate tax rate from 35% to 21% propelling advances in equity prices. Although the economic expansion is 112 months old (second longest in the post WWII period and just short of the 120 month record from 1991 to 2001), no serious impediments to continued growth are apparent over the near term. Renegotiation of trade agreements with Mexico and Canada removes one potential impediment. In contrast, the trade dispute with China, amplified by their territorial claims in the South China Sea, continues to cloud the outlook. Limited wage pressures have kept inflation in check with the CPI rising 2.7% on a year-over-year basis. Core inflation is up 2.2% over the past year. Oil has risen from $64.4/barrel at the beginning of the year to the $76+ level and could move still higher in the coming months. The resultant impact on gasoline prices may move CPI readings to somewhat higher levels.



The growth environment has emboldened the Federal Reserve to continue on their tightening path. The September uptick in the Federal Funds rate brought the targeted level to 2.00-2.25%, the 8th move since the Fed started

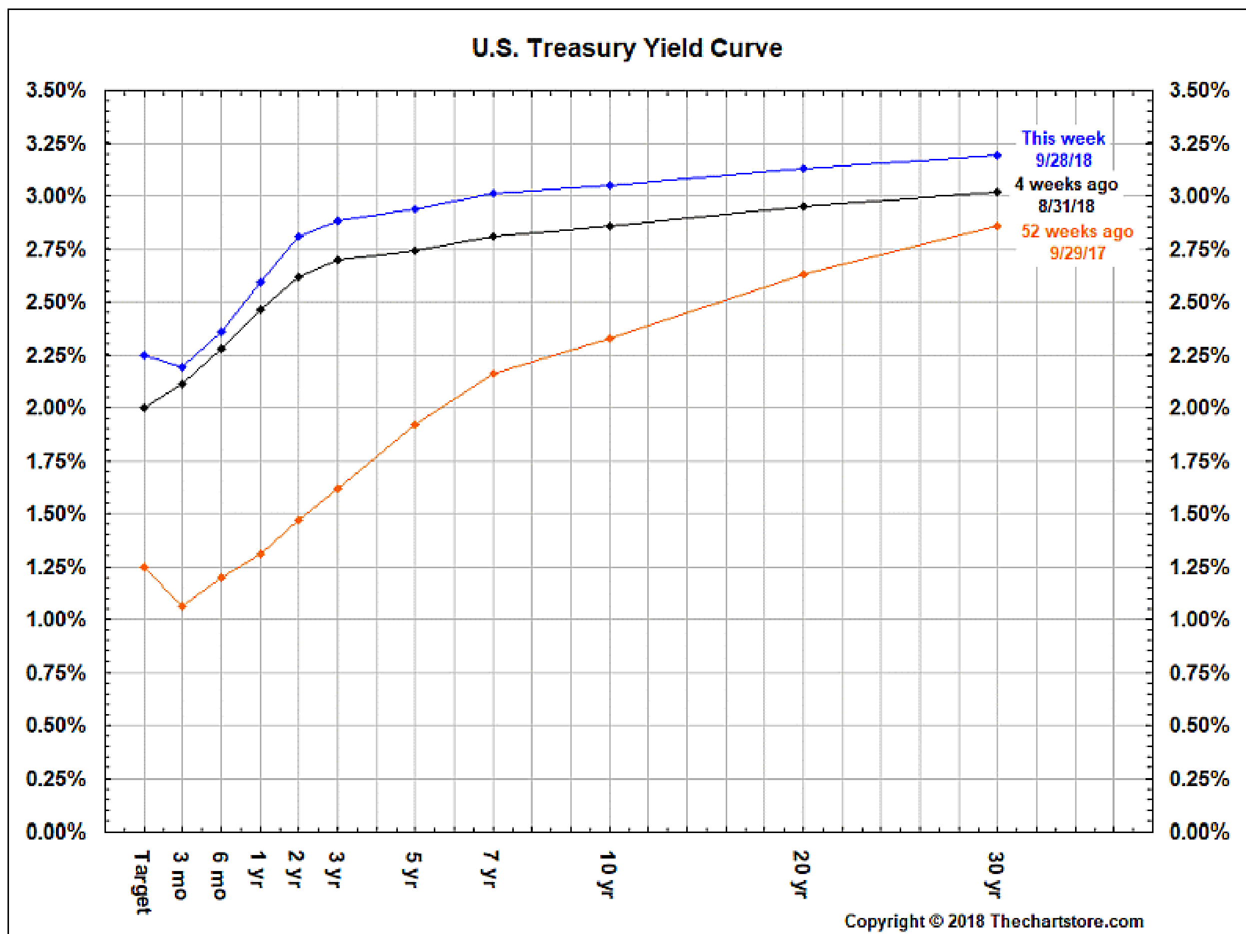
tightening in December 2015. Another increase is expected this quarter with three additional moves in 2019. Assuming continued quarter point adjustments, the Fed Funds rate would be targeted at 3.00-3.25% by the end of next year.

Will longer interest rates move higher in tandem with Fed tightening? As shown in the chart above, the ten-year Treasury yield moved from a 2.05% interim low a year ago to 3.05% at quarter end and is currently trading at the 3.17% level. Some additional upward movement would not be surprising as the economy continues to expand, but we do not expect dramatic increases given limited inflation pressures.

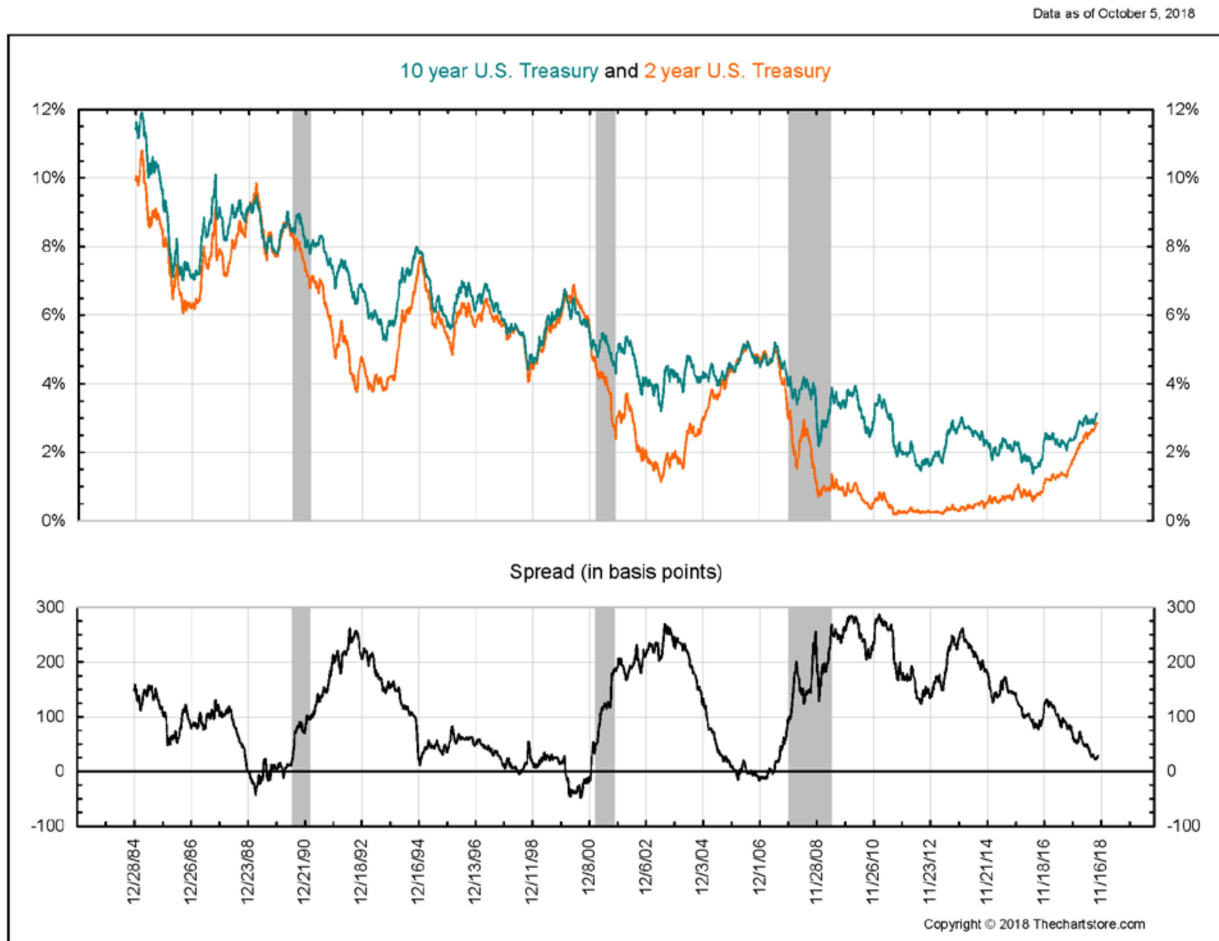
Intermediate product portfolio durations are targeted at 4.00 years, moderately below neutral, to cushion volatility should long rates continue to rise. In our focus on risk control we also continue to use only high quality, liquid credits in managed portfolios.

Flattening Yield Curve

Several articles have recently appeared discussing the flattening of the yield curve in response to Fed induced higher short rates. Recessions are typically preceded by yield curve inversions and concerns have risen as to whether the narrowing spread between two and ten-year Treasury yields is indicating a nearing recession. As indicated in the following Treasury yield curve chart, the quarter end two to ten-year yield spread was 24 basis points, near its narrowest in over a decade. The spread was 51 basis points at the end of 2017 and 81 basis points a year ago. With the uptick in long rates since quarter end, the spread is now 32 basis points (3.17 – 2.85).



The next chart provides a longer-term view of two and ten-year Treasury yields. The grey columns indicate recessions. Most relevant is the bottom panel on the chart that illustrates the spread between these two yields. Yield curve inversion is evident prior to each recession that occurred during the scope of the chart.



As noted above, the economic recovery is nearing record length and, indeed, the yield curve has flattened. However, economic expansions do not die of old age but are typically precipitated by a shock. The tech stock bust and the housing implosion brought on the last two recessions. Aggressive Fed tightening, typically to counteract rising inflation, can also be a recession catalyst. The yield curve can remain relatively flat for an extended period and not precipitate a downturn as it did in the mid to late 90s. We expect that GDP growth will continue through next year, the Fed will maintain their tightening plan, inflation pressures will be contained, long rates will move moderately higher and the curve will remain relatively flat but positive. This view could be jeopardized by trade wars, conflict in the Middle East, a collapse in equity prices, etc. In any such instance there would likely be a rush to safe harbor assets that would enhance the value of the portfolios we manage.

Limited Supply

As mentioned in earlier newsletters, the elimination of refunding issues in the 2017 tax reform legislation prompted a rush of refinancings in the fourth quarter of last year that ballooned 2017 new issue volume to $438 billion. A third of the 2017 issuance was marketed in last year's fourth quarter. Volume in the first nine months of this year was $240 billion, a 12% decline from the last year. A continuation of this trend is expected this quarter with volume for the year forecast to total $320 to $330 billion. Strong demand from individuals for tax-exempt income has been more than ample to absorb available supply, especially in the shorter maturity sector and in high tax states like California and New York. The municipal yield curve is steeper than the taxable curve. The two to ten-year prime

municipal yield spread is 61 basis points compared to 32 basis points along the Treasury curve. Bank and casualty insurer company demand for tax-exempts has declined due to the drop in the corporate tax rate. It has been reported that banks' holdings of municipals declined $16 billion in the first quarter of this year and an additional $6 billion were liquidated in the second quarter.

Municipal yields are not immune from market influences and have risen this year in response to Fed tightening and the rise in longer taxable yields. The table below indicates prime municipal yield levels over the course of the year.

PRIME MUNICIPAL YIELDS				
	CURRENT	6/30/18	3/30/18	12/31/17
1 Yr.	1.92%	1.49%	1.56%	1.41%
5 Yrs.	2.01%	1.65%	1.66%	1.55%
10 Yrs.	2.25%	1.19%	2.04%	1.66%
15 Yrs.	2.62%	2.45%	2.44%	1.98%
20 Yrs.	2.91%	2.66%	2.67%	2.25%
30 Yrs.	3.15%	2.80%	2.93%	2.52%

Higher Short Rates

Until recently strong demand for short maturity municipals caused one-year and shorter securities to trade at very rich levels. One-year tax-exempts yielding 1.60% or less provided only 60% of the like maturity Treasury yield. The sale of a $7.2 billion MIG1/SP-1+ rated Texas note issue last month altered the relationship. Structured with a 4.0% coupon and maturing in August of next year, the notes were priced at 102.13 to yield 1.79%. The size of the issue subsequently caused the offering yield on these securities to move higher and they are now trading near 2.0%. Yields on other one-year maturity securities have likewise adjusted higher.

The upward movement in short rates enhances the attractiveness of the C.W. Henderson Short Term Product. Structured with short effective duration securities, portfolios typically have durations of approximately six months. High coupon intermediate maturity bonds with short one to six month calls are coupled with fixed maturity instruments like the Texas notes and fifteen to eighteen month securities that increase in value as they roll down the relatively steep short end of the yield curve. This vehicle is an attractive option for investors with intermediate liquidity needs and those seeking a flexible option while monitoring longer interest rates and the equity market.

Tight Quality Spreads

Demand for yield has prompted some investors to reduce quality standards and purchase lower quality securities. We again caution against this action. The yield spread between ten-year AAA and BBB tax-exempt securities is currently 87 basis points. It is important to keep in mind that significantly wider spreads have prevailed in the not-too-distant past. During the chaotic environment after the last recession, the flight to quality in all sectors caused the ten-year AAA-BBB municipal spread to balloon to over 200 basis points. We do not anticipate that spreads will widen that dramatically, but if rates rise some widening will likely occur with accelerated declines in bond valuations that will impact portfolio returns.

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