A year ago, we entered 2014 thankful that the volatile 2013 was over. Higher interest rates offered investors hope of a stable rate environment, as global economies did not appear ready for a turn around. The reality of weak global economies led to the ensuing months of declining yields and tightening credit spreads, providing strong returns above investors' expectations. With mutual fund flows turning positive in QII and issuance remaining low until later in the year, the supply/demand fundamentals provided a backdrop for strong municipal performance while global economies were being challenged and inflation was non-existent. An accommodative Fed kept building its balance sheet through October, as Tapering officially ended and resulted in a strong performing bond market for 2014. As we move into 2015, we acknowledge that a repeat of 2014 is not likely, but weak global economies and low inflation remain persistent. Thus, we feel that we are in for a benign year of interest rate moves marked by limited volatility and seasonal pressures that will drive overall performance.

Treasury Yields Remain Range-Bound

A year ago we established a trading range for 2014 on the 10Yr Treasury of 2.80% to 3.50%. Once 2014 started, we traded through the low end of the range and never looked back and, in fact, we did not trade in the range for the remainder of the year. The announcement of the Fed tapering its asset purchases late in 2013 sparked concern for rate increases; but, despite the domestic economy doing better, global economies in Europe and Asia were facing a downturn and deflationary pressures. It was these global pressures, combined with minimal growth and a lack of wage inflation, that led to the rally in interest rates in 2014.

While we continue in this low rate environment, we look to the Treasury Market for some direction on the market. Throughout much of QIII, the ratio of 10Yr Treasuries to AAA municipals had been around 88%, only to increase to 92-94% in QIV. The higher ratios provide the municipal market a cushion against Treasury market volatility. The Fed ended Treasury Asset purchases in October 2014 and despite expectations for an increase in rates, this did not occur. QIV saw the 10Yr Treasury remain in a trading range of 2.10% to 2.50%, finishing the year at 2.17%, down from 2.49% on 9/30. As we stated last quarter, we continue to believe the 10Yr Treasury will remain range-bound during 2015 for the following reasons:

- Europe and Asia are struggling from a growth perspective and deflationary pressures.
- Low global rates, particularly in developed countries, will endure well into 2015, indirectly creating a ceiling on longer-term US rates. At year-end, the German Bund (at 0.54%) was trading 163 bps below the US Treasury 10Yr.
- Geopolitical uncertainties in Russia and Asia have fueled demand for higher quality assets, thus periodically triggering a flight to quality, and also potentially slowing the economic growth momentum for our trading partners in Europe and the Middle East.
- The dual mandates of the Fed – full employment and price stability – continue to be at odds with each other. Inflation expectations are low, with commodity prices dropping led by the collapse in oil prices. On the contrary, the momentum in the labor market remains mostly positive, with average monthly growth in Non-Farm Payrolls at 246k for 2014 and the unemployment rate dipping to 5.6%. However, a drop in the participation rate and a decline in average hourly earnings to a year-over-year increase of 1.7% do not bode well for the strength of the US recovery nor an increase in the Fed Funds Rate.

Impact of Oil Price Decline

Much of the recent turmoil in the capital markets has been driven by the precipitous fall in oil prices and the resulting impacts on oil related stocks. Moving beyond the stock market volatility, it is important to delve into the aftermath of sub-$60 oil and what it means for the economy and those municipalities that are tied to its production, or for Puerto Rico where oil is a costly input of island life. Convention is that the drop in oil prices, and the resulting drop in gas prices, is a form of economic stimulus that puts cash in taxpayers' wallets. According to AAA, the average price of a gallon of gas is currently $2.18, down from $3.31 a year ago. This savings is anticipated to boost discretionary spending in the tens of billions of dollars, which should stimulate the economy. The flipside is the impact on oil producing states and local economies. States like Texas, Alaska, Louisiana, Wyoming, and North Dakota have been riding the domestic production wave, especially for fracking. The result has been job growth, balanced budgets, and fiscal strength. If we reach prices where oil production becomes uneconomical, the decline in drilling will impact jobs. We are watching very closely how the drop in oil prices will impact these states and how gas prices will influence consumer activity.

It is possible that the increased driving due to lower gas prices will highlight the poor condition of our country's infrastructure, specifically roadways. In fact, a recent survey completed by the American Society of Engineers gave US Infrastructure a "D+" grade. Consistent with the austerity measures that have been in place throughout the country since the economic downturn, there has been limited investment in infrastructure projects. Taxpayers are hesitant to approve new revenue sources to finance the projects, and it is politically unfriendly to suggest higher taxes. The long-standing state and federal gas tax is one major revenue source for infrastructure finance. The recent decline in gas prices has increased discussion in some states that it may be time to try to increase the tax. While unpopular, this is even being discussed at the national level as the federal gas tax, at 18.4 cents, has not been increased since 1993.

Supply and Demand Continue to Support Market

On the supply side, austerity measures continue to negatively impact "new money" issuance in the municipal market, which finished 2014 at $144 billion, the lowest in 10 years. Issuance in 2014 got off to a slow start, with total issuance through April down 26% from 2013 levels. However, lower interest rates helped refundings become financially viable, which led to increased issuance throughout the rest of 2014. In fact, a surge in refinancing activity in QIV led issuance to increase 28% over QIV '13. The QIV surge brought total issuance for 2014 to $334.4 billion, flat with 2013. Expectations for 2015 issuance are in the $330 - $350 billion range, with refundings continuing to lead the charge. This is especially likely given the large amount of issuance in 2005 ($408 billion) and the amount of that debt becoming callable, and thus eligible to be refunded in 2015. Additionally, based on the mid-term election results we are beginning to see that austerity measures are easing. During the 2014 mid-term elections, 84% of the $44 billion in bond initiatives were approved. The $44 billion sought to finance schools, water systems, roads, and hospitals was the most in a general election since 2008 and may signal a spending reversal. Thus, it is a good sign that voters are starting to warm to the idea of approving new bond issuance and infrastructure financing.

The flow of money going into municipal bond mutual funds (Funds) continues to add to the demand for municipals. After gathering over $7 billion in flows in QIII, another $8+ billion continued into QIV, pushing total 2014 Fund inflows over $21 billion. There has been a bias for Intermediate exposure, as that category garnered 64% of the inflows for the year. After experiencing net outflows through the end of QIII, Long Term Funds saw inflows in QIV as a sign that investors expect little upward pressure on rates. Anecdotally, we continue to see the 1-10 year part of the investment grade new issue market repeatedly over-subscribed.

The market has been further impacted by net negative issuance, a phenomenon that has contributed to a decline in outstanding municipal debt with more bonds maturing or being called than new bonds being issued. JP Morgan calculated over $48 billion in negative issuance in 2014 and projects an additional $55 billion of negative issuance in 2015. This limited supply has helped regulate the municipal market. Further, Citigroup has identified $10 trillion in the household sector in cash equivalents. If even just a small fraction of this cash currently hoarded by investors waiting for yields to grind higher were invested in Munis, it would help provide market stability if/when rates were to go higher. This would offer another reason why a municipal portfolio is an important part of a broad asset allocation for investors.

Performance Recap

Performance throughout 2014 was driven by curve and credit selection. Despite a very strong performance for the year, the 4th Quarter did not add significantly to the year's overall return. The quarter saw slight selling pressure on the front-end through 5-6 years, while rates beyond 8 years were lower over the quarter, continuing the flattening trend. While the 5-year AAA municipal yield was up 15 basis points (bps) over the quarter, finishing at 1.32%, the 10-Yr AAA municipal yield was down 13 bps to 2.04%. This is consistent with the year's move in which the 5-year was up 8 bps and the 10Yr yield was down 73 bps. This market movement is reflected in the Barclay's Municipal Index performance, as the Barclay's Long Bond Index (22 years and out) was the best performing index, returning 2.36% for the quarter, and up 15.39% for 2014. Conversely, the Barclay's 3Yr Index was the Quarter's worst performing segment of the larger Barclay's Index, returning -0.13% over the quarter, and only up 1.22% for the year. Despite specific ongoing credit concerns, the higher yield in lower rated bonds continues to entice buyers driving lower grade sectors to outperform, with the Hospital sector the best performing sector for the quarter and the year. Other lower grade sectors, such as, Industrial Development and Transportation were strong performers for the year. Credit spreads tightened further for lower grades with the 10Yr AAA-BBB credit spread tightening 12 bps from 109 to 97 and AAA-A spread narrowing by 2bps over the quarter.

Despite further flattening of the municipal yield curve in the 4th quarter, the 2-10 year curve, at 156 bps, remains relatively steep when compared to the 25 year average of 132 bps. We will continue to take our cue from the Treasury Market in this low rate environment, while supply/demand imbalances in the municipal market remain a positive influence. Specifically, we are finding value in the 6-11 year part of the AAA Municipal yield curve. Benign inflation expectations and lackluster economic output drive our expectations for interest rates to remain in a trading range for the foreseeable future. Potential risks to our expectations will likely be driven by changes to the timing and/or magnitude of any Fed action in 2015. With this in mind, we look to continue to manage to our intermediate duration target of 4.65 years, maintain diligence from a credit standpoint, and look to take advantage of value opportunities.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives.