THE BEAT GOES ON IN 2014: LOW YIELDS, TIGHT CREDIT SPREADS DRIVE PERFORMANCE

The third quarter perpetuated a year of declining interest rates and tightening credit spreads resulting in strong performance in the Municipal market. Demand for municipals remains high as evidenced by the over-subscription for new issues and significant mutual fund inflows. As investors grapple with a tepid domestic economy, which has shown some signs of employment growth, global concerns are driving the overarching angst in the market place. Whether concerned about weak economies in Europe and Asia, political unrest in Ukraine and Hong Kong, or disease in Africa, investors have plenty on their minds to keep Treasury rates in the current trading range for the "safe harbor" which they provide. Although Municipals are increasingly taking their cue from the Treasury market, the Municipal market's strong demand, driven by higher state and federal income tax rates and the Affordable Care Act investment surcharge, further supports trading in the asset class.

Supply and Demand Continue to Support Muni Market

The flow of money going into municipal bond mutual funds (Funds) has further contributed to the demand for municipals. After stemming the outflows earlier in the year and turning the corner in QII, the strong flows continued into QIII. Over $7 billion came into Funds in the previous 3 months, and year-to-date fund inflows totaled over $13 billion, marking a nice turn-around versus the $62 billion in outflows experienced in 2013. There has been a bias by investors to shorten their exposure on the yield curve, as long mutual funds saw outflows over the year versus strong inflows for intermediate funds. Also, we continue to see the 1-10 year part of the new issue market repeatedly over-subscribed in investment grade new issues.

On the supply side, issuance continues to underwhelm the Municipal markets. Despite a pickup in recent months led by an increase in refunding issuance, year-to-date issuance is down 10.7% over last year. Lower yields are driving the pickup in refunding issuance, while tight Fiscal budgets continue to drive new money issuance lower, with year-to-date issuance for new projects is down 9% over last year. We do not anticipate an increase in new money issuance as we close out 2014, but we should see additional refundings as we finish the year given the low rates. However, not even an increase in refundings would likely be able to move the market out of yet another year of decreased outstanding municipal supply.

Fiscal austerity measures continue to lead the drop off in new money issuance, which is a result of an economy slowly working its way out of a slump over the last 6-7 years. The lack of new money issuance is gaining attention as municipalities throughout the country are deferring maintenance on their aging infrastructure. We anticipated a pickup in ballot initiatives for this November, but besides two large billion-dollar level deals, there is very little on this year's ballots. Despite voters'/taxpayers' understanding that deferred maintenance and an aging infrastructure will prove more costly down the road, there is just a lack of willingness on the public's behalf to finance these projects. It will be interesting to see how California's $11 billion bond authorization for the State's water system will fare. It is presumed to pass as the State suffers through a severe statewide drought, for which this deal is designed to help remediate the impact. The other large bond initiative is a $2 billion state bonding in New York to help finance technology upgrades for schools across the state.

Improving Credit Trends

Despite names like Puerto Rico, Detroit, and Illinois clouding the municipal credit space, we continue to see broad credit improvement throughout our sectors. Defaults are low, less than $1 billion in defaults year-to-date, which is significantly below the $2.4 billion in defaults through September last year. Interestingly, despite the lack of bond deals, states are looking to improve their reserve requirements and transportation funding on the ballots this November. For example, California has an initiative to increase the State's Budget Stabilization Account from a 5% target of the General Fund to 10%. The increased reserves would be a welcomed boon to the States creditworthiness.

Treasury Yields to Remain Range-bound

While we navigate these markets at rate levels that seem low, we continue to take our cue from the Treasury markets. The ratio of Treasuries to AAA municipals has been hovering in the 88% range for much of the quarter, putting much more emphasis on the direction of the Treasury rates. The Fed began curtailing its monetary accommodation by initiating the taper of Treasury Asset purchases in 2014 with the conclusion scheduled for October 2014. As purchases began winding down, expectations were for rates to trend higher. This did not materialize as the 10Yr Treasury has been in a trading range of 2.35% to 2.65%, finishing the quarter at 2.48%. We continue to believe the 10Yr Treasury will remain in that range for the following reasons:

- While the US recovery is on track, Europe and Asia are struggling from a growth perspective and deflationary pressures continue to take center stage there.

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- Global rates, particularly in developed countries, will continue to remain low well into 2015, indirectly creating a ceiling on longer-term US Rates. At quarter-end, the German Bund (at 0.91%) was trading 157 bps below the US Treasury 10Yr.
- Geopolitical uncertainty in the Ukraine, the Middle East, Hong Kong, and northern Africa have fueled demand for higher quality assets and may periodically trigger a flight to quality; but, this could also slow the economic growth momentum for our trading partners in Europe and the Middle East.
- While the US economy is healthier than most of our peers, (QII GDP revised from +4.2% to +4.6%), the dual mandate of the Fed – full employment and price stability – are somewhat at odds with each other at the moment. The momentum in the labor market is positive, with average monthly growth in Non-Farm Payrolls YTD at 212k and the unemployment rate dipping to 5.9%. On the contrary, inflation is benign, with commodity prices falling across the board.

Performance Recap

Performance in 2014 continues to be driven by curve and credit selection. The bulk of QIII's return came in the first two months of the quarter, as rates from 5 years on out rallied in July and into August. Since Labor Day, 5Yr interest rates and longer began to sell off. Overall for the quarter, 10Yr AAA municipal yields were down 9bps to finish at 2.17%, while 30Yr AAA municipal yields were down 19bps, and 5Yr yields were down 3bps over the quarter. The moves result in a further Bull Flattener, where long-term rates fall more sharply than short-term rates, but still leave us with a historically steep yield curve. This market movement is reflected in the Barclay's Municipal Index performance. The Barclay's Long Bond Index (22 years-and-out) was the best performing index, returning 2.31% for the quarter, up 12.73% YTD, while the Barclay's 1-year Index was the worst performing segment of the larger Barclay's Index, returning 0.07% over the quarter, up 0.54% YTD. Despite specific ongoing credit concerns, the higher yield in lower rated bonds was too enticing for some, leading lower grade sectors to outperform, with Hospital, Industrial Development, and Transportation sectors being the three best performing sectors. Credit spreads tightened further for lower grades with the 10Yr AAA-BBB credit spreads tightening 14 bps from 123 to 109 and AAA-A spreads narrowing by 7bps over the quarter.

A tepid economic recovery and mounting geopolitical concerns are reinforcing our expectations for interest rates to remain in a trading range for some time. While the third quarter saw further flattening of the yield curve, it is still historically steep in the 2-10Yr range, with a pick-up of 173 bps. Specifically for our strategy, we are finding value in the 6-9 year part of the AAA Municipal yield curve. With all of these factors 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 find value in the market as opportunities arise.

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

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