The bond markets have seen a dramatic shift in the past year. Twelve months ago, the Fed's introduction of Taper talk shook the markets. The following sell-off in the bond markets led to the first down year in the Municipal bond market in some time, however six months into 2014, the Municipal market has rebounded strongly. Slack remains in the economy, both domestically and abroad, geopolitical risks are still grabbing the markets' attention, and inflation has not yet reared its ugly head. Fundamentals in the Municipal market remain favorable for investors despite the recent drop in yields and credit spread compression. Mutual fund flows turned positive in the quarter, issuance has been low and will likely remain low, and the tax bills in April reminded investors of the benefit that municipals play in their portfolio allocations. The demand for Municipals is strong, leading to tighter credit spreads and increasing difficulty in finding bonds.

Municipal Supply & Demand

The recent decline on the supply side of the equation has contributed to the difficulty in finding bonds. Issuance year-to-date through 6/30 was $150 billion, down 16% from the same period in 2013. Austerity measures implemented by issuers have kept new money issuance low. Additionally, while low rates had led to an increase in refunding issuance a year ago, the sell-off in the 2nd half of 2013 negatively the economics of refunding outstanding Municipal debt. Only in the last couple of months have we seen a rebound in refundings, and while refunding volume came in at $49 billion year-to-date as of 6/30, it is still down 31% from 2013. However, the recent lows in yields made refundings economical again, driving the pick-up in issuance in June, making it first month of the year in which issuance exceeded 2013 levels.

Another factor contributing to the decline in issuance is an increase in popularity of "Direct Loan Purchases" by banks, an alternative source of borrowing for Municipalities. In Direct Loan Purchase, banks are essentially lending money to issuers, thus bypassing traditional borrowing in the Municipal market place. These loans tend to be shorter in maturity, 3Yr notes according to Municipal Market Advisors (MMA), and have been replacing Variable Rate Demand Note issuance (Short Term financings). However, there have been some new money borrowings for capital projects with longer terms. The result is a cheaper form of financing for the issuers, as they do not have all of the underwriting costs associated with a bond deal, including ratings and bond counsel. MMA estimates $50-55 billion in Direct Loans were "issued" in 2013 with a similar level expected for 2014, resulting in further downward pressure on issuance.

This drop in new issuance coincides with a period of large maturities, coupon payments, and calls, which combined have exceeded new issuance in the market place. In fact, during the July & August period, JP Morgan estimates that we will experience net negative issuance of -$17.8 billion. They expect positive issuance in the fall only to be followed with a negative month again in December, and based upon their new issuance expectations for the second half of 2014, have indicated that we are approaching $35 billion of net negative issuance for the year. This net negative issuance is contributing to the current supply/demand imbalance in the market. Further adding to the demand side of the equation are the mutual fund flows which turned positive in Q2, totaling $5.7 billion year-to-date. Both of these trends are supporting the bid-side for Municipals.

Economic Review

Providing further support for lower rates is an economy which continues to struggle, despite showing positive signs following a weather-induced weak first quarter. The final revision for first quarter GDP, a negative 2.9%, was driven partly by weather issues, but also by the health care component of personal consumption that was initially reported at 9.1% before being revised down to a decline of 1.4%. Labor market statistics are revealing steady growth in non-farm payrolls (averaging 270,000 per month in the second quarter), and an unemployment rate of 6.1% (a level not seen since September 2008), but weaker wage growth, a lower participation rate, and a rise in part-time workers continues to over-shadow the employment growth. Consumer spending, beyond the QI weather meltdown, is sporadically recovering; however has not exhibited signs of staying power to date. Retail Sales have been mixed, but are expected to show a strong recovery in June, and Consumer Confidence, as measured by the Conference Board, is at its highest level in more than six years.

As we move into the second half of 2014, the markets will be looking for 2.5% - 3.0% GDP growth, following on a much stronger second quarter (at ~3.5%). Inflation trends will be closely monitored, as investors try to decipher the Fed's initial timing on rate hikes, especially with the Open Market Purchases expected to end in October. It is no secret that this Fed is more vigilant in the deflation fight than the inflation fight, and may be slower to raise rates in the face of economic strength. We continue to believe that until the labor market (wage inflation) improves, the housing market solidifies, and business investment increases, the Fed will keep rates low, possibly through late 2015.

Credit Update

The credit story in the Municipal market place continues to improve and MMA reports that first time defaults continue to drop, with only 24 issuers defaulting in the first half of 2014 versus 33 and 44 in the same time period of 2013 and 2012, respectively. However, the recent news out of Puerto Rico could impact these numbers. After Puerto Rico came to the market with a $3+ billion dollar deal in March, news out of the Commonwealth had been pretty quiet until late June, when the Puerto Rico Legislature passed the Debt Enforcement and Recovery Act ("Recovery Act"). This legislation provides a mechanism for certain public corporations to restructure their outstanding debt. The legislation notably excludes entities, including the Commonwealth itself, the Government Development Bank, the Sales Tax Financing Corporation (COFINA).

Despite historical support provided by the Puerto Rico central government to these public corporations, the legislation indicates that this backing cannot be expected in the future. Following this, Moody's took broad sweeping credit action, downgrading Puerto Rico credits, citing that the new law "marks the end of the Commonwealth's long history of taking actions needed to support its debt." Moody's downgraded Puerto Rico's GO bonds to B2 from Ba2 and COFINA Senior Lien bonds to Ba3 from Baa1. It appears that the long-maintained assumption that Puerto Rico will always honor its General Obligation pledge may need to be reexamined in light of this legislation. Appleton Partners does not own any non-prerefunded Puerto Rico debt in client accounts.

Market Performance

Performance in 2014 continues to be driven by curve and credit selection. The bulk of the second quarter's return came in the first two months of the quarter, as rates from 5 years and beyond rallied in April and into May. Since the first week of June, 5-year interest rates on out began to sell off. Overall for the quarter, 10Yr AAA Municipal yields were lower by 23bps to finish at 2.26%, while 30Yr AAA municipal yields were down 37bps, and 5Yr yields were down 11bps. The rate moves led to a Bull Flattener, where long-term rates fall more sharply than short-term rates. Even after this move, we are still left with a historically steep yield curve. 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 4.11% for the quarter, up 10.2% YTD. The Barclay's 1-year Index was the worst performing segment of the larger Barclay's Index, returning 0.22% over the quarter, up 0.47% YTD. Despite specific ongoing credit concerns, the higher yield in lower rated bonds was too enticing for some. The demand for higher yield led lower grade sectors to outperform, with Hospital, Industrial Development, and Transportation being the three best performing sectors. Credit spreads tightened for lower grades, with the 10Yr AAA-BBB credit spreads tightening 9 bps from 132 to 123 and AAA-A spreads narrowing by 5bps.

Appleton Municipal Strategy Focus

We have been targeting our trading in looking to take advantage of recent market anomalies. As we indicated, the yield curve remains steep, as does the credit curve. The latter means that for like credits, the additional credit spread an investor earns by selling the 2-4Yr bond and buying the same name in the 6-10Yr part of the curve can often lead to 15-25bps of additional credit spread. An extreme example of this is the recent spread tightening in California State GOs. According to MMA, 3Yr CA state GO bonds earn an investor 4 additional bps of credit spread over the AAA Municipal yield curve, while an investor in 10yr CA state GO bonds will earn an additional 29bps over the AAA yield curve. We have also been looking to move between sectors that offer additional yield without impacting our credit profile. As credits spreads have tightened in the GO and Water & Sewer sectors, we can find value through selling these tighter credits and re-investing in sectors like Special Tax bonds or Public Power bonds that may offer additional yield in the same part of the yield curve.

Despite further flattening of the yield curve in the second quarter, we still have a historically steep yield curve, with a pick-up of 198bps in the 2-10Yr range. Specifically, we are finding value in the 5-9 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. 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 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.