The Fixed Income markets started the year strong, which was a surprise to most investors. After a volatile 2013, expectations were for further selling pressure, especially with the 2013 tax season on the horizon. Instead, we began the year with a flight-to-quality trade in Treasuries and profit taking in the equity markets. Global economic concerns from Europe to Asia and the Ukraine contributed to the tightening Treasury curve. As Q1 was winding down, market opinions were mixed as participants interpreted that Janet Yellen's comments in mid-March implied potential Fed Fund rate increases may be sooner than expected in 2015, which put pressure on the 3-5 year part of the yield curve. Meanwhile, the market was faced with declining supply, a reversal of Municipal mutual fund flows, mixed economic data, wealth creation from increased M&A activity and IPOs, and the realization that one of the best ways to escape the tax law changes was to buy tax-exempt Municipals. The bid side for Municipals remains strong, driving credit spreads tighter and leading to strong demand for new issues.

Mixed Economic Picture

Severe weather is being blamed for the renewed softness in the economic data released in the first quarter; however, there were other headwinds that may have impacted consumer behavior as well. The expiration of emergency jobless benefits, the confusion in the implementation of the Affordable Care Act, and the higher 2013 tax liability for many investors may have driven behavior domestically. A sales tax increase in Japan and more anemic growth in China created additional concerns from a global perspective. Interpreting the data continues to pose a challenge to the markets. While home prices have held steady, new and existing home sales and starts, all reached near term peaks in the third and fourth quarters of last year. As rates trended higher and the cost of financing increased, first time buyers and institutional investors backed away. Weekly initial jobless claims have been trending lower, the jobless rate is holding steady at 6.7%, and job creation as reflected in the non-farm payroll data registered a monthly average of 178,000 in the first quarter, which are all reasonably good signs. However, other factors that are tracked by the Fed, such as underemployment, labor market participation, and wage growth are struggling to improve and are not yet reverting to pre-crisis levels.

Personal Consumption Expenditures (YOY), a favorite metric tracked by the Fed to gauge inflation, has been hovering at 1.1% for the past six months and shows no signs of accelerating. The Fed has indicated that they would tolerate an inflation level that was .5% above their 2.0% target, sending the message that we are far from realizing a monetary tightening as a result of inflationary pressures. While the FOMC continues to reduce monthly purchases (currently at $55 billion versus the 2013 level of $85 billion), the issue of the pace and timing related to raising short-term rates is less clear. Yellen's comments after the March 19th meeting indicated that a 6 month lag between the end of the taper and the rise in the Fed Funds rate might be appropriate. Her comments related to the labor markets, also indicated that the 6.5% threshold unemployment rate might not trigger any action by the Fed as they are assessing a broader range of data. Lack of consensus within the Fed itself became apparent when the minutes are released on April 9th.

Municipal Supply & Demand Imbalances

As much as the talking heads like to make "macro" observations that yields are low and can only go higher as the economy heats up and the equity markets deliver compelling returns; the underlying strengths of the municipal market remain evident when viewed on the pure fundamentals of "supply and demand." New issue supply continues to decline, impacting the overall availability of municipal debt outstanding as more bonds are maturing or being called than actually coming to the marketplace. In March 2014, volume was down 16% over March 2013 and YTD issuance was down 26% from Q1 2013. Refundings have dropped 52% YTD over 2013, as higher rates have made refinancing debt more difficult. Meanwhile, fiscal austerity remains, resulting in a 2.3% decline of new money issuance for Q1 2014 over Q1 2013. The growing infrastructure needs will likely challenge this trend, especially after the harsh winter which left damaged roads throughout the northern half of the country. In fact, many states are focusing on the increasing need for infrastructure projects and we will likely see initiatives on November ballots proposing bond deals to finance these projects.

For now, however, the trend of "net negative issuance" in the Municipal market continues. In just the first 2 months of the year, we saw more bonds mature or called than were issued, resulting in "net negative issuance" of $19 billion. In 2013, the Municipal bond mutual fund outflows totaled over $60 billion and the decline in issuance and bonds outstanding helped to stabilize the market. Since these flows have moderated in 2014, the bid side for municipals has firmed up. As of 3/31/2014, we saw a total of $1.2 billion in net outflows. This overall number was largely driven by the $4.6 billion in outflows from long-term mutual funds, while Intermediate funds have actually seen net inflows YTD, according to JP Morgan. The strong interest in new issues persists and deals continue to be multiple times over-subscribed in the 1-10Yr range, meaning too much interest for too few bonds.

The increased demand for Municipal bonds is both a function their relative value and income tax changes that went into effect for the 2013 tax year. Three new tax burdens, an increase in the top income-tax bracket to 39.6%, the 0.9% additional Medicare tax on income exceeding $250,000, and the net investment income tax of 3.8% to finance the new Affordable Care Act, have increased the overall tax bill for many investors. A double incentive for Municipal investors is that Municipal income is not subject to the Affordable Care surcharge. The Urban-Brookings Tax Policy Center, a bi-partisan think tank which provides independent analysis of tax issues, has analyzed Federal tax rates for the top 1% of tax payers. The Center projects that the recent changes will cause this group to reach an average tax burden approaching an effective rate near the highs reached in the late 70's. This reality has highlighted the significance of the tax favored treatment of Municipal income and is contributing to the demand for the asset class.

Credit Research Remains Key

The Municipal credit story has been improving for some time as we witnessed 16 consecutive quarters of total state tax collection increases, improving fund balances for states, and a decline in defaults. However, a diverging view from the major rating agencies, S&P and Moody's, is still putting pressure specific credits. Moody's has placed increased weight on a municipality's overall liabilities, including pension funds, leading to a large number of downgrades. Meanwhile, S&P has grown more positive on improving credit conditions for most sectors of the market, which is leading to an increase in credit upgrades. This phenomenon coupled with the big, yet isolated credit stories of the moment, Puerto Rico, Illinois, and Detroit, continues to heighten the awareness and need for diligence and independent credit research.

Market Performance

Performance in the quarter was driven by both curve and credit selection, with the bulk of the quarter's return coming in the first few weeks of the year, as rates from 5 years on out rallied in early January. Since the last week of January, interest rates in the 10Yr part of the yield curve have been generally flat while 5Yr rates began to increase after Yellen's comments in mid-March. Overall for the quarter, 10Yr AAA municipal yields were down 28 bps to finish at 2.49%, while 30Yr AAA municipal yields were down 54bps and 5Yr yields were up 7bps over the quarter. The moves result in a 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, as the Barclay's Long Bond Index (22 years and out) was the best performing index, returning 5.83% for the quarter, while the Barclay's 1-year Index was the worst performing segment of the larger Barclay's Index, returning 0.24% over the quarter. Despite specific ongoing credit concerns, the higher yield in lower rated bonds was too enticing for some. Within the Index, lower grade sectors led performance, with the Hospital, Industrial Development Bonds, and Tobacco being the three best performing sectors. Credit spreads tightened for lower grades with the 10Yr AAA-BBB credit spreads tightening 22bps from 154 to 132 and AAA-A spreads narrowing by 11bps.

Municipal Strategy Focus

Despite the flattening of the yield curve in the first quarter, we still have a curve which is historically steep in the 2-10Yr range, with a pick-up of 210 bps. Specifically, we are finding value in the 5-9 year part of the AAA Municipal yield curve. The volatility we highlighted last quarter remains and continues to influence our thoughtful approach to managing the portfolios. 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 duration target of 4.7 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.