Spinnaker Report

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AHW &Co Quarterly Commentary

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While the “January effect” definitely occurred in 2016 as we expected, the duration of this rally has been a surprise. With very few pauses municipal bond yields have continued to decline even though supply has been consistently heavier. Tax free bond mutual funds have witnessed over 25 consecutive weeks of cash inflows. We mentioned in our last newsletter that demand was insatiable, and this trend has continued, pausing only during major economic and Federal Reserve announcements. California came to market with approximately $3 billion in general obligation bonds on March 7th and had over $25 billion in orders for the securities. The new issues we target for participation are frequently 10 times oversubscribed. Some of this can be attributed to a flight to quality as investors have fled riskier assets. Even a recent back up of approximately 30 basis points in US Treasury yields has had little effect on municipal bond prices.

"**The best attack is a good defense**" is an adage that has been applied to many fields of endeavor. Also known as the **Strategic Offensive** principle. Generally, the idea is that Proactivity (a strong offensive action) instead of a passive attitude, will lead to a strategic advantage.

This best explains our current investment strategy. Attempting to predict the bottom for yields is the equivalent of trying to catch a falling knife. The only current certainty seems to be that we live in uncertain times. Our preferred philosophy now is to play good defense. What this means is that although we have been reducing the average monthly leverage in all of our client accounts, we have continued to aggressively trade and utilize leverage capabilities on an intra-week basis. With absolute rates this low and the spread between margin costs and coupon rates this narrow it doesn’t make much sense to employ an aggressive carry trade orientation. For now, we are content to trade opportunistically and take the profits that we are able to manufacture by exploiting the inefficiencies in the marketplace and our superior market access.

We remain believers in the seasonality factors that affect municipal bonds. Generally, April is a period of caution as the amount of reinvestment cash is minimal and income taxes need to be paid. While no indicator is 100% accurate as witnessed this past fall when the market continued to rally even through negative seasonals, we look at any significant back up in yields as a buying opportunity. Our practice has been to sell what we consider overvalued portfolio holdings and replace with undervalued securities. A case in point is Tennessee bonds. There is no personal income tax in TN but the State does levy the “Hall Tax”, which applies a 6% tax on out of state municipal bond income. This provides a built in demand for Tennessee bonds and the amount of issuance is considerably lower than many other states. We were able to purchase large blocks of Met Nashville and Davidson TN for Lipscomb University and also a similar deal for Vanderbilt University Hospital System. While we traded some, our strategy is to hold many for a time when there is no Tennessee paper available. California is another focal point and appears undervalued given the metrics mentioned in the research report on page 4. We have been aggressively purchasing CA bonds.

The most recent Federal Reserve meeting concluded with no change in rates but signaled an acknowledgement by the Central Bank of global risk considerations. The US economy appears to be insulated as evidenced by improved recent data on jobs, retail sales, housing, etc. but continued fears about European and Chinese growth prospects have placed interest rates on divergent paths. Much has been said about negative interest rates. Japan recently established the policy and its 10 year bond currently yields -.05% while the German Bund traded at .11%. Without a doubt these are significant observations but it is unlikely that the US would adopt similar policies.

Many times we have reiterated that our management strategies are not dependent on interest rate predictions but rather on our experience in exploiting municipal market inefficiencies. As we enter the next quarter we remain cautious and optimistic that the seasonal market forces will present more opportunities to produce returns for the benefit of our clients.

Negative Yields From Paris to Tokyo Draw Investors to U.S. Debt
2016-02-02 14:24:00.103 GMT
By Cordell Eddings

(Bloomberg) -- After seeing their borrowing costs rise to their highest level since 2012, U.S. companies may have at least one ray of hope: yield-starved foreign investors.

Those money managers are holding about the largest percentage of the market on record, about 31 percent of the $9.5 trillion of U.S. corporate bonds outstanding, according to Federal Reserve data, up 7 percentage points since 2009. They have a real incentive to keep buying. After the Bank of Japan cut rates below zero last week, yields on more than $7.1 trillion of government debt globally are negative, while yields on U.S. investment-grade and junk bonds are rising to their highest levels in four years. Demand from foreign investors may help prevent corporate bond prices from weakening much further, said Gareth Isaac, a London-based money manager at Schroders Plc., which oversees $646 billion. “It’s hard to make money anywhere else,” Isaac said. “The yield is better, the companies are in relatively better shape, the pool of assets is bigger. To investors, not just from Europe, but from Japan and China, the U.S. looks very attractive.” Schroders has been adding to its U.S. corporate bond positions recently.

Foreign investors are buying all kinds of U.S. assets, not just corporates. International purchases of U.S. securities increased by $31.4 billion in the three months ended December, the sixth straight quarter of inflows, Treasury Department data show.

Money managers are looking for securities that will offer a positive yield for relatively less risk as growth slows outside the U.S. and foreign central banks boost stimulus.

Bonds issued by American companies look attractive relative to U.S. government debt. The average yield on a U.S. investment grade corporate bond is 1.96 percentage points higher than a Treasury note, according to Bank of America Merrill Lynch Indexes, the highest risk premium since mid 2012. “The U.S. market has cheapened off so much,” said Chris Bowie, a money manager at Twentyfour Asset Management in London, which oversees about 5.5 billion pounds ($7.9 billion). Twentyfour sent a portfolio manager from its investment grade team and a colleague who covers high-yield bonds to New York just before Christmas to seek out “compelling opportunities,” according to Bowie.

Whatever difficulty is brewing in the U.S. economy, other countries face an even tougher time. The commodities slump has pushed Brazil deeper into recession, and plunging oil prices have hobbled Middle East crude producers. Deutsche Bank strategist Jim Reid posits that it’s only a matter of time before yields on corporate bonds sold by investment-grade European companies dip below zero in light of continued central bank easing and a sustained rally in the region’s debt. "Our central view is that zero might be a temporary resistance point if government yields rally further but that at some point the dam will break and corporates will trade on a spread basis and go sub-zero," Reid wrote in a note published on Tuesday.

Little Choice

Economists polled by Bloomberg expect China’s gross domestic product to grow at a 6.5 percent this year and 6.3 percent next year, compared with an estimated 6.9 percent rate in 2015 and levels well above 7 percent since at least 2008. The global economy will expand 3.4 percent this year, down from a projected 3.6 percent in October, the IMF said in a quarterly update to its World Economic Outlook. “Investors will have little choice but to put more money into foreign denominated bonds,” said Yoshihiro Nakatani, a senior fund manager at Asahi Life Asset Management Co. in Tokyo.

Investing in U.S. corporate debt is hardly a slam dunk. If U.S. growth gets dragged down by the rest of the global economy, the bonds may look like less of a sure thing. Still, foreign investors have more than doubled their share of the U.S. company debt market in the past 20 years, a proportion that has been growing steadily. Foreign ownership was at a record 32.3 percent in the second quarter of last year, and some investors believe it could rise again from the 31.4 percent reported for the third quarter last year in December.

If these investors slowed their buying, U.S. companies would notice the difference, David Nowakowski, the London-based director of fixed income research at Barings Asset Management, said in an e-mail. Their borrowing costs may well rise, he added. “The increase by non-U.S. owners has indeed been torrid,” Nowakowski said. “U.S. assets are safer and in many cases higher-yielding.”

Rally in Longest Muni Bonds Drives Yield Gap to Eight-Year Low
2016-03-29 12:51:12.389 GMT
By Brian Chappatta

(Bloomberg) -- The longest-dated municipal bonds haven't looked this expensive since before the 2008 financial crisis.
Yet investors aren't showing any signs of slowing their purchases.

Following a rally that began in the second half of 2015, the extra yield buyers pick up for holding 30-year debt instead of two-year securities fell last week to as little as 1.96 percentage points, the lowest since February 2008, according to data compiled by Bloomberg. The difference shows investors are anticipating that bonds maturing in decades will fare best at a time when inflation is subdued and the Federal Reserve is planning to raise short-term rates.

The so-called flattening of the yield curve has made a lot of people look prescient: Investors and analysts at more than half a dozen firms including Barclays Plc, Citigroup Inc., Janney Montgomery Scott and Morgan Stanley Wealth Management all predicted the move in December. Some say long bonds could extend the rally through year-end amid signs that individual buyers are no longer waiting for yields to rise from five-decade lows.

"We've come a long way in a few months, but going forward, munis can hold onto this flatness or flatten even further," said John Dillon, managing director at Morgan Stanley Wealth Management in Purchase, New York. "Individuals have this greater comfort that long-term rates aren't going to get away from them, and they're getting the idea that reinvesting in two-year paper isn't producing any kind of return."

Even though the Fed raised its target rate in December for the first time since 2006, few expect significantly higher interest rates as other countries seek to combat a slowdown in growth. The futures market is factoring in a 6 percent chance the U.S. central bank will raise rates at its meeting in April, down from the one-fifth that was predicted a month ago.

On Monday, the Commerce Department reported that its price index for consumer purchases, a gauge closely watched by the Fed, dropped 0.1 percent in February from the month before, underscoring the lack of upward pressure on inflation.

For muni buyers in particular, the outlook is promising after weathering the usual wave of new bond offerings in March, which typically weighs on prices. States and cities issued $35.6 billion over the past month and the tax-exempt market gained
0.08 percent, according to data from Bank of America Merrill Lynch and Bloomberg.

"The long-end of the muni curve continues to look quite attractive, while the short-end should continue to cheapen,"
said Phil Fischer, head of municipal research at Bank of America in New York. "Continued curve flattening seems like a reasonable bet."

Individuals are speculating on the longest-dated debt outperforming. They've added money for 25 straight weeks to long-term muni mutual funds, which represent about two-thirds of overall tax-exempt fund inflows during the period, Lipper US Fund Flows data show.

Amid the demand, the yield on an index of benchmark 30-year munis is 2.73 percent, compared with 3.18 percent when the streak of inflows began, Bloomberg data show. By contrast, benchmark two-year rates, at 0.76 percent, are up from 0.56 percent, as traders price in another quarter-point Fed increase by the end of the year.

Not every investor is going all-in on the longest-maturing securities. Bonds due in eight to 12 years offer a better value for investors because prices haven't rallied as much, said Jamie Pagliocco, who oversees muni-bond funds at Fidelity Investments.

Yet even he sees the appeal of long-term debt for investors who are losing patience with muni-market yields that are stuck near the lowest since the 1960s.

"There can still be a fair amount of demand on the long end because of the absolute yield levels," said Pagliocco, whose company oversees $32 billion of munis. "The longer rates sit around this level, the more comfortable people get."

Reprinted : Siebert & Co Research

WHY CALIFORNIA DEBT "SHOULD" OUTPERFORM THROUGH THE SUMMER MONTHS

We see a potential SUPPLY/DEMAND imbalance in the California market, which we attempt to quantify in this piece.

When we examined the statistics for California cash flow from bonds called and maturing vs California tax free issuance (DATA BELOW) our conclusion is that tax free paper in the State SHOULD CONTINUE TO HAVE CONSTANT demand and OUTPERFORM for the next several months, perhaps longer.

In the interest of being conservative, we have REMOVED coupon payments from the cash flow equation, which in our opinion, makes the results stand out even more.

Upon review of statistics below, you may see why we have come to this conclusion.

Since 2010, the issuers in California have seen $5,546,488,000 more in debt MATURE than has been ISSUED (this statistic does not take into account 2016 cash redemptions verses supply). Even after 2016, there will be a cash surplus not counting coupon payments.

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There is no other major State issuer of debt that has a surplus/imbalance since 2010, or has shown a 5 or 6 year trend of reducing outstanding fixed debt.
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If you took California coupon payments into the equation from 2011 to 2016 California derived cash would have a surplus of $107 BILLION (2016 coupons are $16,642,305,000).

If you remove 2016 coupons there is $90.3 Billion in excess California derived cash.

Continued Projections for California paper in 2016

California paper will be a very sought after Investment in 2016 where approximately $41.5 billion in California debt will mature or be called in 2016.

Tax free new issuance will be in the $39 to $43 Billion area.

If we come in at $43 Billion we still have a 6 year surplus of $4 Billion more cash from bonds called and maturing in the State than new issuance.

Below are the statistics:

In this data, you will see what we used in the body of the report above.

As previously noted, NO OTHER State (all issuers in the State of California) has this imbalance, and we think that it really comes down to Supply/Demand as in all economics, and that the DEMAND has been exacerbated by at least 2 ancillary factors:

The resurgent California Economic engine, notably in TECHNOLOGY industry has been producing JOBS/INCOME, that have a Multiplier effect in real estate, services, recreation, dining etc…and as a result: Tax Revenues for the Cities and State.

These Tax revenues STRENGTHEN the Credit and concurrently increase DEMAND from high net worth/ high tax filers.
The successful passage of HIGHER INCOME Tax rates in November of 2012 BEGAN the tightening of California debt due to the perception of MORE revenues and MORE demand as a result of higher tax rates.

Investors anticipated and have actually, seen this and have experienced, a much improved, more disciplined Fiscal state of affairs, an improved credit rating, lower issuance and more oversight by the State, coupled with higher taxes has driven demand, at a time when replacement debt is falling BEHIND cash flow.

BONDS MATURING IN CALIFORNIA (2006-2016)
2013, 2015 and 2016 are all Outliers, exceeding $40 Billion
The Trend began in 2011 and is much, much higher than the readings in the 2006-2010 years.

STATISTICS FOR 2016

CASH COMING BACK TO INVESTORS THIS YEAR IN THE 2016 CALIFORNIA REDEMPTION CYCLE IS NOW A MINIMUM $40 BILLION WHICH IS ON THE "EXTREMELY" CONSERVATIVE SIDE IN OUR OPINION. Maximum number is now projected to be $44 BILLION+ ($8,335,575,000 of that total is coupon payments if you don't want that statistic added.)

2015 had $42,469,484,000 in debt maturing, called and coupon payments paid in the State during this 7 month time period.

$8,017,797,000 was coupon payments if you want that statistic taken out.
$16,161,995,000 in debt was called in 2015.
(Largest total ever was 2013's $44,238,565,000 in cash flow).

SUMMARY

While the par amount of deals one year ago ran about $4.5 Billion per month after April, and April was a tad low on STATE sponsored deals, it really fell off. We saw some Cities, Utilities and County debt in the State, but no real critical mass.

The Deal size was not larger than 300mm or so, with many, many smaller deals in the mix. We expect a similar pattern to present itself in 2016 as well after the large LA MICLA deal that is issued in May.

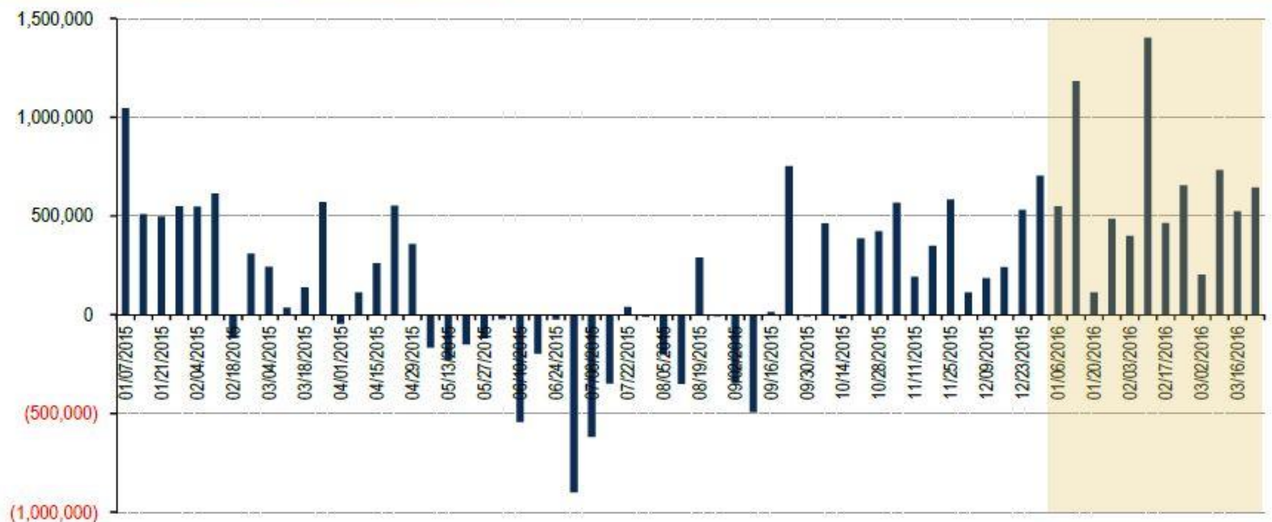
We see a few San Diego & Los Angeles deals visible, but we are fairly certain that most, if not all, of the Fiscal 2016 debt left to do will be issued in April, maybe some spilling into May, then a lull until the Fiscal year turns on July 1st and paper is issued in last week of August, first week of September like the past few years.
It is because of how deals are issued by the State of California that from the beginning of May to end of August the supply of all issuers of California backed debt can't keep up with the cash flow of California debt through Bonds called & maturing.

If one adds in coupon payments, the abundance of cash will drive demand for the next 5 months. It appears quite evident to us as we trade the cash flows.

Currently, the market is riding 26 consecutive weeks of inflows into mutual funds. This contributes to the “insatiable appetite” for bonds the tax free market is experiencing.

We are practioners of a seasonal approach in our portfolio management. These factors generally turn negative in April in a kind of a reversal of the January effect we have frequently elaborated on. More supply, less demand and taxes to be paid usually equate to a “April softpatch”.

While we don’t necessarily expect fund flows to turn negative anytime soon, we are respectful of the seasonal observations.



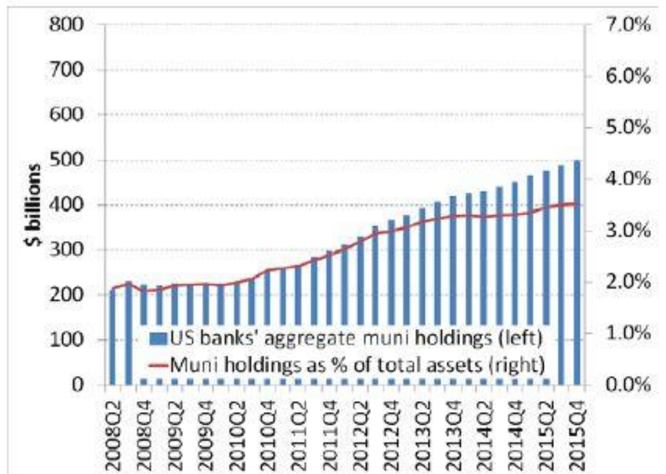
Municipal bonds have been one of the best asset classes to own over the last couple years.

It is not surprising that US banks have taken advantage of the relative value opportunities versus other taxable fixed income securities.

Figure 13. US banks have decreased their corporate holdings...

Source: Citi Research

Figure 14. ..while increasing their municipal holdings



Source: Citi Research

Various factors have compressed municipal bond spread relationships:

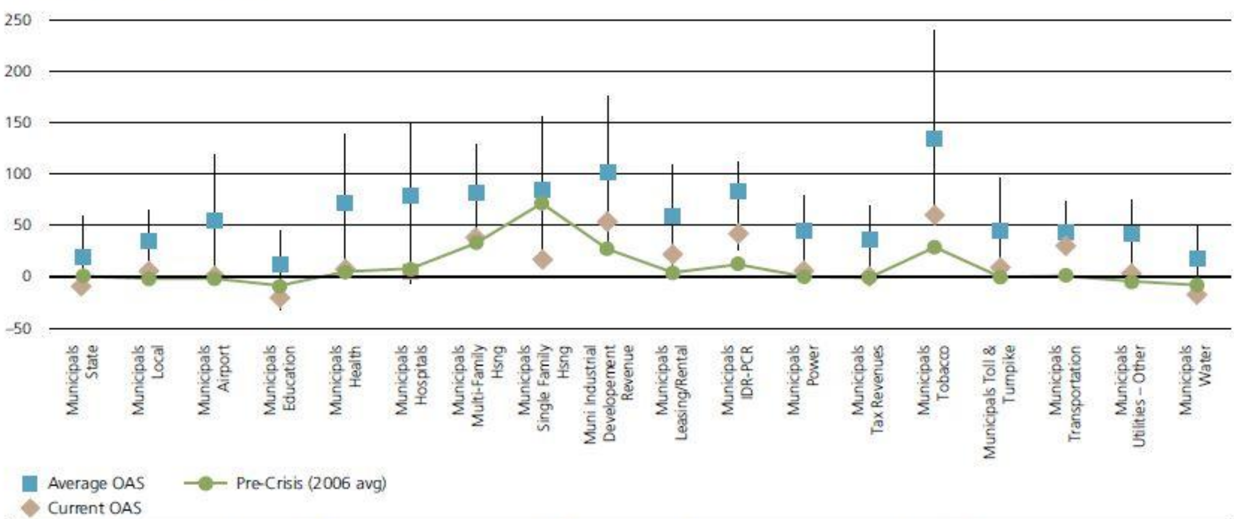
1-State and local government revenues have continued to rise.

2-Rating upgrades exceed downgrades.

3-Investors are seeking higher yielding securities

Fig. A8: Municipal sector spreads (2010 - present)

Option adjusted spreads, in bps



Note: The vertical line represents the range of spread from 2010-present while the square marker shows the average spread over the same time period. The diamond marker shows the current spread and the circle marker shows the average spread in 2006.

Source: BofAML, UBS, as of 14 March 2016

Muni Funds See Most Cash Since '12 on Best Risk-Adjusted Returns
2016-04-01 09:42:34.575 GMT
By Brian Chappatta

(Bloomberg) -- When it comes to risk-adjusted returns, municipal bonds still can't be beat. And individual investors are taking notice.

The $3.7 trillion municipal market earned about 0.3 percent in March, building on gains of 1.1 percent and 0.1 percent in January and February, Bank of America Merrill Lynch data show.

It's just the second time since 2002 that the debt has posted three straight positive months to start the year. While the first-quarter return is merely on par with the average over the past decade, individuals are pouring money into tax-exempt bonds anyway. They've added to municipal bond mutual funds for 26 straight weeks dating back to October, the longest streak since 2012, Lipper US Fund Flows data show.

With tax-exempt interest rates near the lowest since the 1960s, munis don't seem alluring on their own. Rather, they offer a combination of relatively higher yields and lower volatility that's hard to match in the global markets, explaining why individuals continue to favor them, according to investors and analysts at BlackRock Inc., Loop Capital Markets, Oppenheimer & Co. and Vanguard Group Inc. When adjusted for price swings, state and local bonds performed better than many major asset classes in the first quarter, just as they did last year.

"As long as rates stay where they are right now, and you get to earn the coupon, I think retail investors are OK with that," said Chris Mier, chief strategist at Loop Capital Markets in Chicago. "Munis are a good place to hide."

When accounting for risk, as measured by price volatility, the broad municipal market earned 0.95 percent in the first quarter through March 30, data compiled by Bloomberg show. That edges the 0.94 percent return on investment-grade corporate bonds. U.S. Treasuries, high-yield company debt, commodities and the Standard & Poor's 500 index of stocks gained 0.75 percent,
0.36 percent, 0.12 percent and 0.08 percent, respectively.

Last year, munis did even better, returning 2 percent on a risk-adjusted basis while other assets either eked out gains or declined.

U.S. stocks plunged briefly into a correction in August 2015, which may have steered some investors into munis, Mier said. The current streak of inflows, totaling about $22 billion, began in the first week of October.

The S&P 500 recouped most of its losses later last year, only to plunge to the lowest in nearly two years on Feb. 11. The same week the index touched the low, investors added $941 million to muni funds, the fourth-largest inflow of the current stretch.

"Oftentimes we see investors looking in the rear-view mirror -- they look at what has done well and buy that," said Chris Alwine, head of munis in Malvern, Pennsylvania, at Vanguard, which oversees $157 billion of the debt. "We've been a bit surprised by the level of inflow."

April will test demand for munis -- funds have seen outflows in at least one of the first two weeks of the month each year since 2010, Lipper data show. That's because individuals tend to raise cash ahead of the U.S. tax-filing deadline in mid-April.

Investors may also react to price declines from mid- February to mid-March, which drove benchmark 10-year yields up
0.3 percentage point to 1.87 percent, said Sean Carney, head of municipal strategy at BlackRock in New York.

"Many look at fund flows in the municipal-bond market as a leading indicator, when in all actuality they're a lagging indicator -- they lag past performance," said Carney, whose firm oversees $110 billion in munis. "It wouldn't be surprising if we were to begin to see fund flows compress a bit. They've been very strong."

Tax season also has a positive effect for munis: reminding investors how much they pay, and what they could save by earning tax-exempt interest. Including a 3.8 percent levy on the investment income of top earners resulting from the 2010 Patient Protection and Affordable Care Act, the highest federal rate is
43.4 percent.

That means the 1.75 percent yield on benchmark 10-year munis is equivalent to 3.1 percent on a taxable basis for top earners. That compares with 1.77 percent on U.S. Treasuries and exceeds the rate on 10-year bonds from Australia, Canada, China, almost all European countries, New Zealand, South Korea and Thailand, Bloomberg data show.

"People are looking at this external volatility and they want to put their money into something that's more stable and consistent," said Jeffrey Lipton, head of municipal research at Oppenheimer in New York. "If you're within the upper income-tax brackets, and if diversification and preservation of capital is an important investment objective, why wouldn't you put money into munis?"

Municipals Might Not See Usual Tax Season Selloff: McDonnell
2016-04-04 11:04:47.533 GMT
By Taylor Riggs

(Bloomberg) -- Tax season is approaching and it has investors thinking of ways to diversify and improve their portfolios. Dawn Mangerson and Jim Grabovac, managing directors and senior portfolio managers at McDonnell Investment Management-- an affiliate of Natixis Global Asset Management -- spoke with Bloomberg Radio's Taylor Riggs about why municipals might not see a seasonal selloff this year.

Q: We're coming up on tax season and it's always a good time to review munis because they are tax free. Can you make the case why munis are attractive relatively to Treasuries or corporate bonds?

Jim Grabovac: They are quite attractive at current valuations. One of the things that transpired over the course of the last several months is diminished supply in the market and valuations tightened up as we came into January. And it was a typical January effect. But since that time the muni curve has actually steepened somewhat. And yields have moved somewhat higher from say 10 years on the curve out longer versus the Treasury market, which has rallied pretty substantially and the yield curve has flattened. If you look at current valuations versus Treasuries, in the 10-year spot of the curve it's about even. The AAA tax-exempt municipal is yielding the same as Treasuries. If you look at an investor in the maximum marginal tax bracket -- both on a federal level then plus the 3.8 percent Medicare surtax -- you have an effective rate of 43.4 percent. If you compare a AAA municipal yield in 10 years of roughly 2 percent on an after-tax basis, you would have to go down in credit quality to BBB on the corporate side to get a similar after-tax yield.

Q: Traditionally around this time we see a selloff in the muni market as people pay their taxes and sometimes liquidate their muni holdings. Do you expect that to be the case again this year -- seeing more pressure in the market around the April time period?

Dawn Mangerson: We usually see some outflows during the tax season. What might mitigate that this year is we've had such strong inflows into the muni market so far so there is some cash sitting there waiting to be invested that can be used for tax purposes as opposed to having to liquidate into the market. So I actually think the market should hold in there pretty well this year.

JG: You've also had a pretty flat market last year and even into the first quarter of this year. On the equity side of the equation it's virtually unchanged. And similarly, interest rates are little changed over the last five quarters so you may have less of a capital gains tax liability at the margin and that might mitigate some of the liquidation activity.

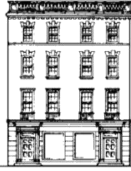
Q: I want to switch over to Treasuries. As we came into 2016, there were a lot of research notes talking about how munis outperform Treasuries in a rising rate environment. And as we look to the Fed for direction, do you expect that to be the case where munis will follow like they did back in 1994 and outperform the Treasury market in a rising interest rate environment?

JG: We think the interest rate environment has been substantially different than what we've come to consider normal. We are in a very low rate environment and our expectations are that with the U.S. economy doing relatively well the Fed will continue to move further off the zero lower bound. It is their intention to get rates up somewhat. They've had more of an impact on the shorter part of the curve than on the longer part of the curve, which has been held in check by weak inflationary conditions globally. In terms of municipal performance versus Treasuries, what will typically occur and what has historically occurred if interest rates do rise, you will have supply in the municipal market decrease at the margin because the refunding mechanism tends to slow down. And typically lower supply will help performance of municipals relative to Treasuries.

Q: Can you talk to me about your views on bond insurance?
Because yields are so low, would you rather do your credit research and pick up extra yield or do you like the safety and comfort that bond insurance provides?

DM: We here at McDonnell have been happy not to have to invest in a market that is 50 percent coming as insured because it's nice to be able to pick up additional yield by doing our credit research on every individual credit. What this allows investors is more yield in a low-yield environment and a lot of municipal credits -- it's a high credit quality market and a lot of municipal credits right now are rated higher than the insurers currently. So I think we look at it as an advantage to investors to be able to buy without insurance. That being said, there is still a lot of outstanding debt that has insurance on it and that is not a negative. It's still a positive.

JG: Our view at McDonnell has always been to look at the underlying credit quality first and foremost and then secondary insurance as an added benefit if it's in place.



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