A.H. Williams

Spinnaker Report

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The global search for yield continues!

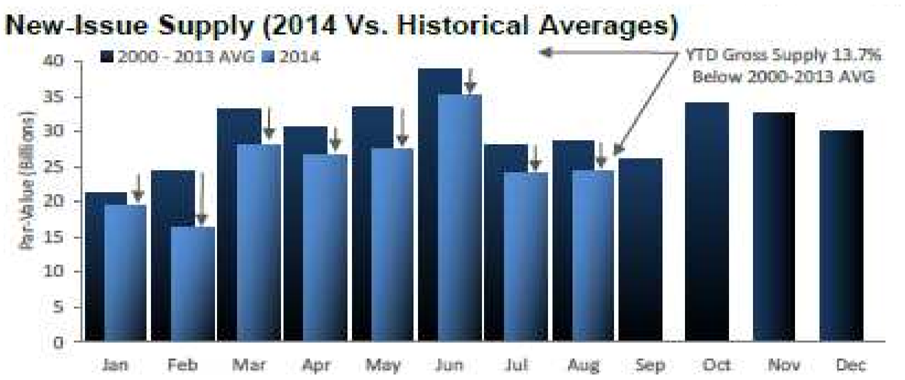
Not surprisingly, the municipal bond market continued to perform admirably the 3rd quarter, much as we envisioned in our last newsletter. What is unique is August, which traditionally is the definitive month for summer doldrums, produced one of the strongest monthly returns of the year. The combination of a dearth of new issue supply and an insatiable demand for bonds reduced yields an average of 14 basis points in 5 years and 27 basis points in 30 year maturities according to the widely followed MMD scale. The market continues to experience “negative supply” effects which occur when the amount of bonds being redeemed due to maturity or being called plus the amount of interest payments exceed the supply being newly issued. This amounts to a classic supply and demand imbalance. This observation is not exclusive to municipal bonds. As economic weakness continues in the Eurozone, various stimulus measures have been taken driving foreign sovereign debt to yields not previously witnessed. While many interest rate forecasters had predicted US Treasury yields to increase, just the opposite has been occurring even in lieu of the ending of the Federal Reserve QE3 bond purchases. The spread between foreign rates, specifically the German Bund, and the US 10 yr note has widened to record levels. Investors have the choice of investing money in Bunds at a rate of .94%, the French 10 yr at a rate of 1.28% or the US 10 yr at 2.49%. Clearly, the value is in the US bond market even as the Fed debates normalization of policy and interest rates. This underlying bid has taken up the slack of any Federal Reserve stimulus exit pressure. Add some geopolitical pressure to the mix in the form of Russia-Ukraine and ISIS and the safety of US Treasuries is compelling.

Investors in municipal bonds are facing the increasingly more difficult task of sourcing bonds as their bond holdings mature or are called. With 10 year tax free bond yields averaging approximately 2.5%, many buyers are extending maturities or downgrading in quality in the search for yield. This would explain recent flattening of the yield curve and tightening of spreads between high grade and lower grade bonds. Mutual funds flows have been generally positive, which further exacerbates the low supply observations. While many market participants looking for the projected rise in interest rates have capitulated due to excessive uninvested cash, others are waiting for the supply calendar to build in hopes of taking advantage of price concessions if and when such a supply bulge occurs.

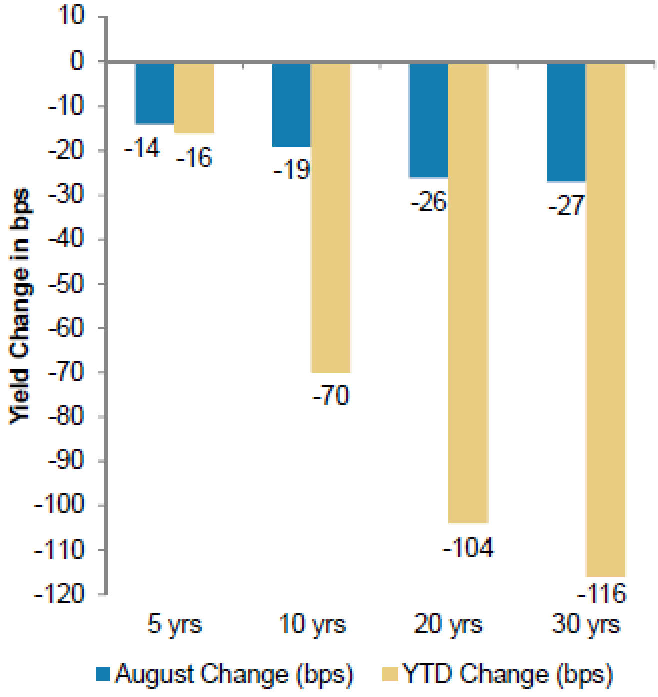
Our strategy has been to be opportunistic. We have sold into this rising price, declining yield environment and in the process have reduced leverage in all client portfolios. At the same time, we have concentrated on value based high turnover trading to provide gains and enhance portfolio performance. While we are currently in a defensive posture and respect the possibility of rate hike discussions to negatively impact the market, we believe the aforementioned global economic and supply considerations are likely to mitigate and insulate the bond markets from any rising yield pressures. Short term rates are likely to rise over the next several years. It is not hard to envision the yield curve continuing to flatten in response. In short, we may be in this trading range for quite a while.

We will continue to search for value and implement our active trading philosophy. When the opportunity presents itself our investment team is prepared to exploit market inefficiencies for the benefit of our clients.

Decreased Supply + Increased Demand = Rising Prices



1-A. Rates Rally in August



Source: Morgan Stanley Research, MMD, as of 8/29/14