A.H. Williams

Spinnaker Report

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The end of June demonstrated the power of a flight to quality bid, with the surprise results of Brexit being the impetus for a broad based fixed income rally. Sustainability is always an issue with such a large move and the summer of 2016 really was more about consolidation than anything else. Generationally low interest rates are becoming more acceptable now after 8 years of experiencing rounds of global quantitative easing, creating a level of complacency that many are now pointing to as a longer term problem. Money has flowed consistently into fixed income investments and municipal securities have now experienced over 52 consecutive weeks of inflows. In prior newsletters we referred to an ‘”insatiable” appetite for tax advantaged products which still exists but in a much more muted manner. Once rates declined below 3% maximum yield retail investors went on a miniature yield strike. Focus has now shifted away from Brexit and the global picture to what is now going on in the US. The Federal Reserve seems to want to resume what they call normalization by raising interest rates. To date this has not occurred for several reasons, one being it is an election year, and another that there are mixed signals regarding the strength of the US economy. The combination of these factors has led to a small back up in rates. The 10 year US Treasury note has traded in a range from 1.3% to 1.70% and the 30 year from a 2.2% to 2.45%. Yields on municipal bonds have risen an average of 20-30 basis points.

Our strategy this past quarter has been to trade opportunistically and selectively when our models suggest reasonable risk – reward. This has provided our clients with some insulation from the mark to market reductions in portfolio value due to the mild back up in yields. Additionally, we have begun taking profits on some of our structured bond holdings. Since most of our client portfolios include some sort of leverage, the difference between the margin interest charged by the custodian and the yield being earned on portfolio is very important. As an example, we don’t generally want the cost of margin to exceed the yield invested. Our preference is for what’s known as “positive carry” which is when the invested yield exceeds the margin rate which is currently at approximately 2.5%. Several of our holdings have experienced a significant price rise as interest rates have dramatically decreased this past 12-18 months. When we identify such holdings that are trading at yields below the current margin rate we have flagged them for sale. Ideally, these sales are on bonds we have owned beyond 1 year and are eligible for long term capital gains treatment.

Continued on next page

Adaptability is becoming an extremely important characteristic as we enter uncharted territory in the marketplace. As we have stated in the past, our strategies do not include making interest rate predictions. Beginning in the spring of 2015 we noted that our orientation was about to change and we were implementing a reduction in average leverage across all accounts. This was done primarily as a cautionary approach to the generational lows experienced in interest rates and as a hedge against event risks. Our view has been and continues to be that municipal bonds provide a compelling investment option, especially when viewed on a taxable equivalent basis. While we have gotten more conservative with average leverage, we have been very aggressive in exploiting and trading market inefficacies utilizing our resources to actively seek and provide short term profits throughout 2016. Due to this, performance has exceeded even our most optimistic expectations. Needless to say, we are happy that even though a more conservative approach has been adopted performance has not suffered. As we enter the last quarter of 2016 we believe there will be a period of volatility relating to the Presidential election and the outlook for a new administration. Our intent is to maintain a defensive posture and continue utilizing our experience and market access to take advantage of trading opportunities.

It is a pleasure to share with you some news. AH Williams “Advantage” separately managed account strategy was named by Barclay Hedge #1 for the 3 year period ending June 2016. Nexxt Level Total Return Fund was awarded #3 for the same 3 year period in the category of “Long Only Credit”.

Most noteworthy and important to us is the recognition that over a 3 year period our methodology and strategies have exceled versus our peers.

Barclay Hedge Fund Index

The Barclay Hedge Fund Index is a measure of the average return of all hedge funds (excepting Funds of Funds) in the Barclay database. The index is simply the arithmetic average of the net returns of all the funds that have reported that month.

The Barclay Hedge Fund Index is recalculated and updated real-time on this page as soon as the monthly returns for the underlying funds are recorded. Only funds that provide us with net returns are included in the index calculation. The number of funds that are currently included in the calculations for the most recent months can be found in the footnotes below. Please note that the calculation for the number of funds is time-stamped and that the number of funds will continue to increase until all funds categorized within the sector have reported monthly returns.

About BarclayHedge

BarclayHedge is dedicated to serving institutional clients worldwide in the field of hedge fund and managed futures performance measurement and portfolio management. BarclayHedge, formerly known as The Barclay Group, was founded in 1985, and consists of a team of research specialists, programmers, and data admin personnel experienced in alternative investments.

Please note: BarclayHedge is not affiliated with Barclays Bank or any of its affiliated entities. We are a privately owned Iowa corporation.

From its origin as a research specialist and performance measurement firm, BarclayHedge has developed complete client services as a publisher, database and software provider, and industry consultant. A critical factor behind BarclayHedge's success - both in its research and consulting roles - has been the BarclayHedge Alternative Investment Database. This computerized database tracks and analyzes the performance of 7151 hedge fund and managed futures investment programs worldwide. Based on our over 25 years of experience in data collection, research and consulting services, we have established long-standing relationships with many of these managers. These relationships have proven themselves to be of great value to our clients.

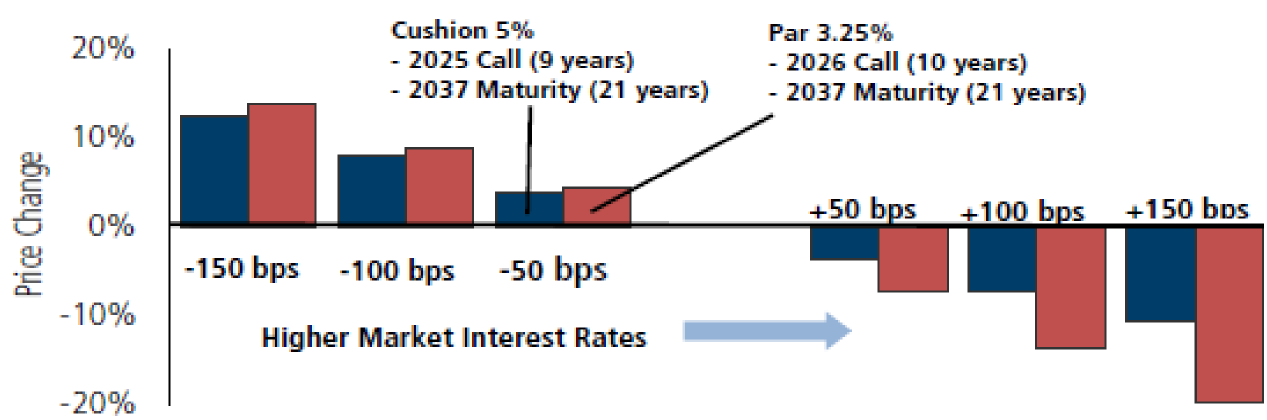
The BarclayHedge Databases, the BarclayHedge Fund Database and the BarclayHedge Managed Futures (CTA) Database, serve as the basis for research reports and performance rankings that appear in BarclayHedge's various publications and directories. BarclayHedge is one of the foremost sources for proprietary research in the field of alternative investments. Much of the research is summarized in the quarterlyBarclayHedge Managed Funds Report.
BarclayHedge has created and regularly updates 18 proprietary hedge fund indices and 10 managed futures indices. The BarclayHedge indices are utilized worldwide by financial media and investment consultants as performance benchmarks for the alternative investment industry.

Maintenance and growth of the BarclayHedge Databases requires continuous performance monitoring, discussion, and review. BarclayHedge's extensive interaction with alternative asset managers around the globe, combined with its proprietary analytical tools, gives the BarclayHedge team a unique perspective and in-depth knowledge of the alternative investment industry and its universe of managers. As a BarclayHedge subscriber, you can utilize that knowledge and perspective to structure investment portfolios that offer global market participation and risk diversification.

A significant portion of our active trading strategies require participation in the "retail" marketplace where discount structure is the most profitable and provide the greatest risk-reward opportunities.
As we sense directional headwinds our priority is to shift gears and reduce exposure with the intent of holding a majority of "cushion bonds" in all accounts.

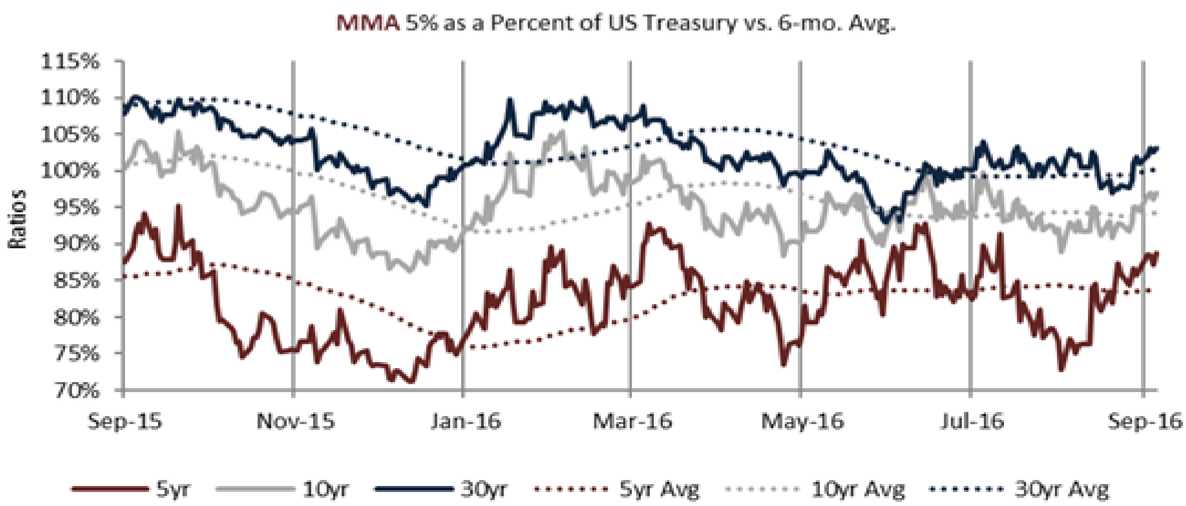
Each of our client portfolios contain core positions of higher coupon bonds trading at a premium or commonly referred to as cushion bonds. As the attached chart shows, these bonds tend to outperform bonds trading at par or a discount during rising rate environments.

Cushion Bonds are More Defensive in Rising Rate Environments



Source: Janney Fixed Income Strategy, Municipal Market Analytics, Bonddesk (9-13-16)

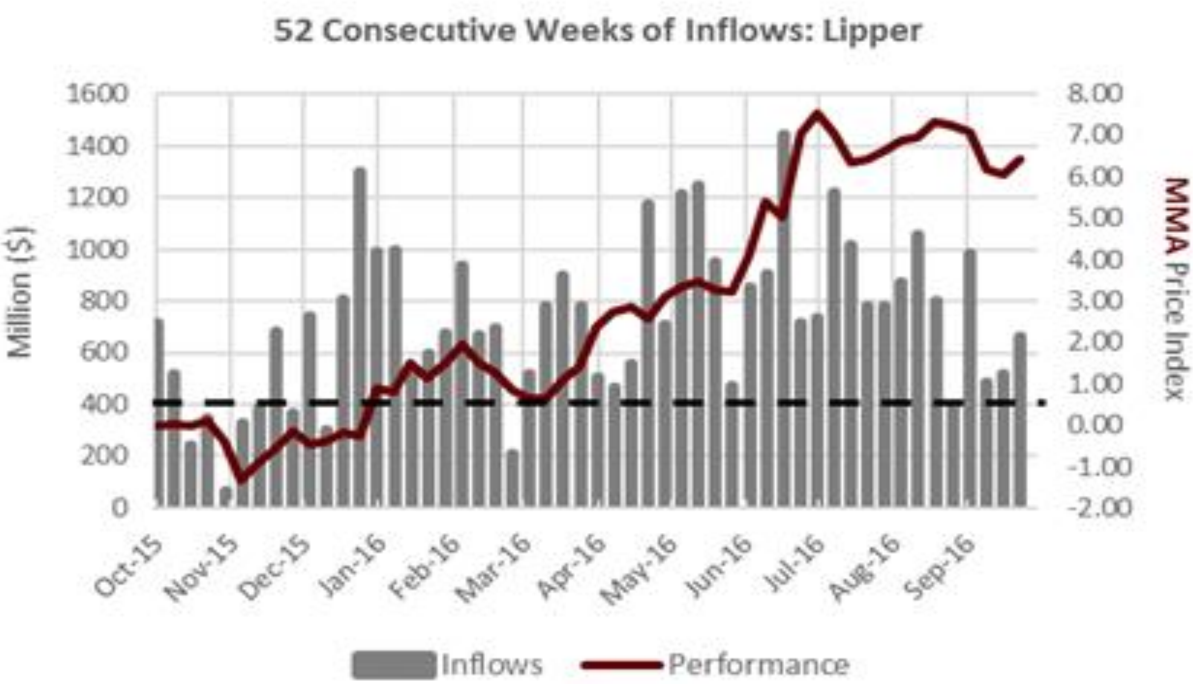
Municipal securities have been trending toward the cheap side of the spectrum relative to their UST counterparts.



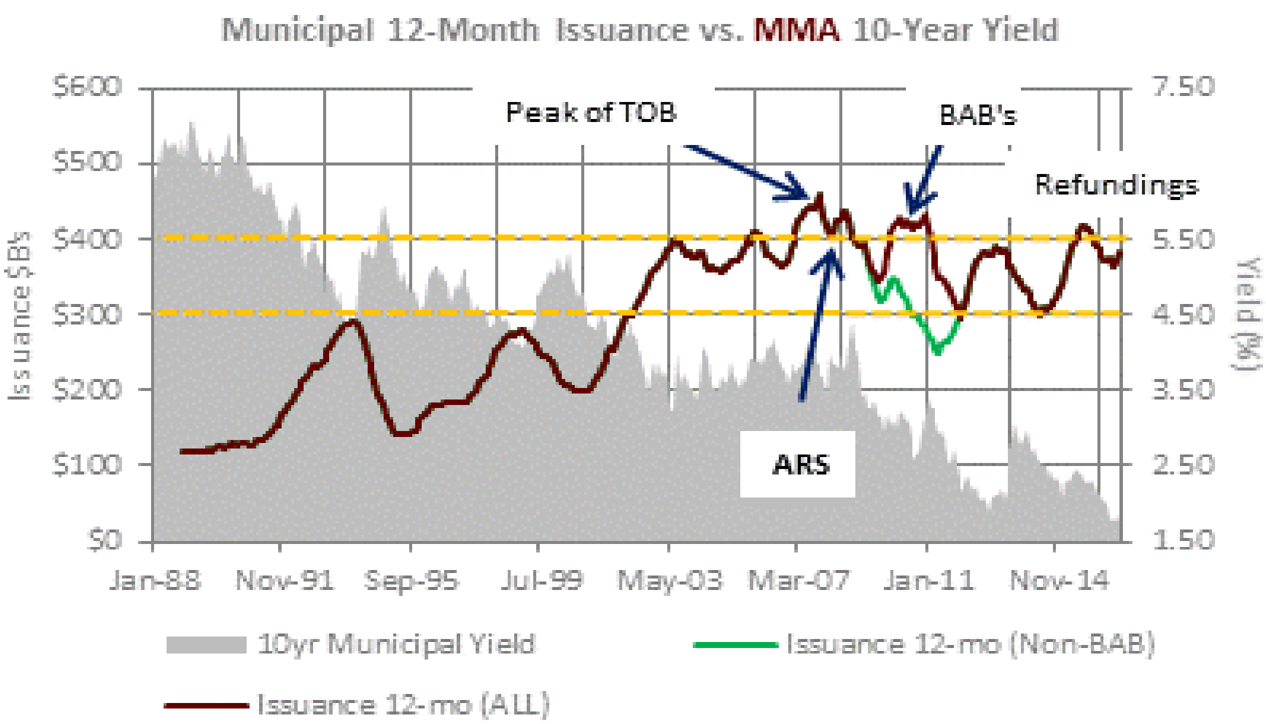
The graph below tracks the 5-, 10-, and 30-year relative value ratios (**MMA** 5% / UST) compared to their 6-month averages. Relative value ratios rose further above their 6-mo. Averages.

Investors continue to allocate money to municipal securities.
We now have experienced 52 consecutive weeks of inflows into municipal mutual funds.

Record issuance is expected during the 4th quarter of 2016. If these fund flows continue, it should lend some stability to the marketplace in lieu of the anticipated volatility related to the changing political landscape and other potential headwinds.



The Bulk of 2016 experienced demand in excess of supply. For the first time in quite a while the focus will now be on the supply side of the equation. This will produce headwinds but also will provide significant trading opportunities.



Source: MMA research

The continued push for issuers to take advantage of the well diversified demand is apt to drive the annual issuance above $400B. Should the 12-month total crest above the $400B barrier, it would be the first time since November 2015. However, excluding the BAB issuance of 2009-10, the prior time issuance was above $400B was October 2008.

This table shows the relative move in rates for generic AAA rated <u>municipal securities for the month of September and year to date</u>

AAA MMD CHANGES FOR THE MONTH ENDING SEPTEMBER 30TH, 2016

	8/31/16	9/30/16	CHANGES
5 YR	.86%	1.02%	+ 16 BPS
10 YR	1.42%	1.51%	+ 9 BPS
15 YR	1.76%	1.91%	+ 15 BPS
20 YR	2.00%	2.16%	+ 16 BPS
25 YR	2.07%	2.26%	+ 10 BPS
30 YR	2.12%	2.31%	+ 19 BPS

AAA MMD CHANGES FOR THE YEAR TO DATE ENDING SEPTEMBER 30TH, 2016

	12/31/15	9/30/16	CHANGES
5 YR	1.26%	1.02%	-24 BPS
10 YR	1.93%	1.51%	-42 BPS
15 YR	2.30%	1.91%	-39 BPS
20 YR	2.55%	2.16%	-49 BPS
25 YR	2.75%	2.26%	-49 BPS
30 YR	2.82%	2.31%	-51 BPS

Yearlong Rush Into Muni Funds Leaves Investors Wary of an Exodus
2016-09-28 09:00:00.3 GMT

By Romy Varghese

(Bloomberg) -- Investors have plowed money into municipal- bond funds for almost a year, allowing local governments to borrow at near record-low yields. That’s making it easier to ignore the cracks beneath the market’s surface.

This week may mark the 52nd straight one with inflows into state and local-government bond funds, the longest streak since 2010, according to Lipper US Fund Flows. Even with the influx, the securities are headed toward the biggest monthly loss since February 2015 on speculation the Federal Reserve may raise interest rates in December. If investors start yanking money out, that could weigh on prices because securities firms have pulled back from the market.

“There’s this anxiety that’s looming under the surface where people are saying, everything is going really well, there’s all these muni inflows but what happens if that stops suddenly?" said Katie Koster, a managing director in public finance investment banking for Piper Jaffray Cos. in Laguna Beach, California. "How will the markets react? They could seize up quite quickly."

The municipal market has been whipsawed in the past when mom-and-pop investors dumped their bonds en masse. Prices tumbled in late 2010 amid concern the recession would trigger a wave of defaults, a fear that later proved unwarranted. The securities dropped again in 2013 during the so-called taper tantrum, when then-Fed Chair Ben Bernanke jarred investors with plans to scale back the central bank’s bond purchases.

The influx of cash for the past year has been fostered by stock-market volatility and negative interest rates overseas, which have made even rock-bottom municipal yields attractive by comparison. Foreign buyers, who don’t benefit from U.S. tax breaks tied to the debt, increased their holdings to $89.7 billion at the end of June from $74 billion three years earlier.

The streak of cash "shows strong investor demand for an income-producing asset class that has high credit quality, low volatility and continues to act as a diversifier against equity and equity-like risk," said Sean Carney, head of municipal strategy at BlackRock Inc., which manages about $124 billion of municipal debt. "There’s no indication that flows are about to turn negative, just less robust."

Municipals have produced a return of 4 percent in 2016, according to Bank of America Merrill Lynch data, thanks to a rally that came as the Fed held off on interest-rate increases that were anticipated this year. The central bank indicated this month that the case for tightening monetary policy has strengthened, and the securities posted a loss of 0.5 percent in September.

Despite the wall of cash that’s allowed even junk-rated borrowers to issue debt, governments continue to deal with mounting pension-fund shortfalls that are exerting a drag on their credit ratings. And the impact of a selloff could be exaggerated by the brokerage industry’s diminished role in the market since new regulations went into effect after the financial crisis: Dealers’ holdings fell to about $20 billion at the end of June, down by half from $40 billion in mid-2011, according to Fed data.

"Investors have to be careful about not lulling themselves into a false sense that this abundant liquidity in the market right now is driven by dealers," said James Iselin, head of the municipal fixed income team in New York at Neuberger Berman, which oversees about $10 billion. "It’s really driven by investors and asset managers who have pumped a lot of money into the space."

To prepare, he said investors should buy bonds from highly- rated governments even if they offer less yield than more speculative ones.

"Giving up a little bit more to be more flexible and nimble for an environment that could be less liquid, that’s a trade that investors should certainly think about right now," he said.

But with the interest rates so low, investors have been doing the opposite, said Piper Jaffray’s Koster. "That could be a problem down the road."

Japanese Investors So Desperate for Yield They'll Buy U.S. Munis

2016-10-06 13:17:22.714 GMT

By Romy Varghese

(Bloomberg) -- Tetsuo Ishihara, a strategist for Mizuho Securities in New York, started fielding phone calls a couple months ago from Japanese clients interested in U.S. municipal bonds, which usually have little allure overseas because federal tax breaks depress the yields.

But with negative interest rates on Japanese bonds due in as many as 10 years and near record-low payouts on Treasuries, he discovered that state and local debt demanded attention. Even highly rated municipals are delivering bigger returns than U.S. government bonds, without the risk that comes with corporate securities.

"The risk return looks pretty good," said Ishihara, U.S. macro strategist for the Tokyo-based brokerage, who sent clients a report in September showing how municipals stacked up favorably against other fixed-income investments. "The default rate for munis is much lower than for corporates. All that fits with what they need."

Increasingly, investors outside the U.S. are contributing to the cash that's flowed for a year into the $3.8 trillion municipal market, which caters largely to Americans willing to accept low yields because the income is exempt from U.S. taxes. By the end of June, foreign buyers had increased their holdings of the securities to $89.7 billion, about triple what they held a decade earlier, even though they don't get any of the tax benefits.

Investment firms have courted the business. Shinsei Bank Ltd. and Western Asset Management, a unit of Baltimore-based Legg Mason Inc., last year started a private fund that invests in municipals for Japanese financial institutions. In March, Eaton Vance Management's co-director of U.S. tax-exempt bonds was among those who spoke at an investment forum the firm co- sponsored in Tokyo.

Columbia Threadneedle Investments got its first account from Japan about a year ago and within six months anticipates that it will have at least $200 million from insurers, diversified financial companies and other clients in Asia, said James Dearborn, head of tax-exempt securities at the Boston- based firm. The funds are primarily invested in taxable municipals, which carry higher yields.

"They've come to like the idea that munis represent a relatively stable asset class and that the default incidence is very, very low for a long period of time," said Dearborn, whose firm manages $24 billion in state and local debt. "They're creating demand we didn't have before, and that's a good thing."

U.S. municipal bond funds have pulled in money for 52 weeks straight, the longest stretch since 2010, according to Lipper US Fund Flows. Such demand pushed municipal yields to the lowest on record by early July, before they edged back up amid speculation that the Federal Reserve will resume raising interest rates as soon as December.

Even with the influx of funds, 10-year municipal revenue bonds with an AA rating yielded about 1.94 percent by the end of trading Wednesday, or 0.23 percentage point more than Treasuries, according to data compiled by Bloomberg.

Dearborn and Ishihara expect the interest to remain strong, regardless, as investors look for havens from equity-market swings and central banks around the world hold yields near zero.

After Ishihara published his report, Japanese clients peppered him with questions, showing they had already been looking closely at the market.

Considering the environment of low rates and inflation, "the credit cycle could last maybe more than two years," he said. "It could continue for a while."

Commentary: A price to pay for long-term low interest rates
Updated: SEPTEMBER 29, 2016 — 3:01 AM EDT
By Antony Davies
and James R. Harrigan

The Federal Reserve has held interest rates at near zero for so long that many have forgotten that near-zero rates are not normal. And when we finally do return to normal, there's going to be a very large bill to pay.

To help hold interest rates so low for so long, the Fed has increased bank reserve balances by 20,000 percent over the past decade, flooding financial institutions with enough reserves that borrowing money, literally, costs almost nothing. The Fed's target interest rate, the federal funds rate, which averaged 5.7 percent from 1955 through 2008, has averaged just 0.1 percent since 2008, which has lowered interest rates across the board for eight years.

While low interest rates are a boon for home buyers and college students, they don't come without danger. If the Fed isn't careful, the increase in bank reserves that spawned those low rates will eventually also spawn massive inflation.

For years, the Fed has signaled that it intends to start rolling back bank reserves, thereby allowing interest rates to rise. But apart from a paltry three-tenths of one-percent increase in December of 2015, the Fed hasn't raised interest rates since 2006.

The debate among Fed watchers has centered on the trade-off between inflation and recession. If the Fed raises interest rates too late it risks significant inflation, but if it raises rates too early it risks recession.

As bad as those options are, the debate misses a crucial point. While the Fed has been holding interest rates at near zero, the U.S. government, has gone on an unprecedented borrowing binge.

In 2006, the federal government owed $8.5 trillion. Today it owes $19.5 trillion. As interest rates rise and fall, so too does the interest rate the federal government pays on its debt. That rate currently stands at 2.2 percent. But in 2006, before the Fed's intervention, the federal government paid 5 percent on its debt. That almost three percentage point difference in interest rates doesn't seem like much, but on a $19.5 trillion debt, it is astronomical.

If the Fed were to allow interest rates to return to prerecession levels, the federal government would owe an additional one-half trillion dollars annually in interest payments. There are only three ways to come up with that much every year.

Washington could raise taxes by about 16 percent across the board. The federal government could borrow more, effectively doubling its current budget deficits, and accelerating the growth of its already massive federal debt. Or it could cut spending by 14 percent across the board.

Voters won't stand for higher taxes. And given that the last time Washington cut spending by more than 3 percent was 1955, there isn't much hope for budget cuts either. That leaves only increased deficits.

This is what Fed watchers should be talking about. The Federal Reserve has painted itself into a corner. If the Fed tries to return interest rates anywhere close to their prerecession levels, it will cause deficits to balloon permanently, which will accelerate the growth of the now $19.5 trillion debt.

Complicating matters, the federal debt is not long-term debt. Almost 60 percent of the federal debt will mature within four years. An additional 30 percent will mature within the subsequent six years. That means that, as interest rates rise, the federal government will only have a couple of years' grace before it has to start refinancing large chunks of its low-interest debt at higher rates.

Sometime, possibly within months but certainly within a few years, the Federal Reserve will have to choose between the people and the government. When inflation starts rising, the Fed can either raise interest rates, which will dramatically increase federal deficits, or it can let inflation rage, which will decimate people's savings.

The third way, a 14 percent across-the-board cut in spending, is the only way to stave off the devastating effects of decades of fiscal irresponsibility. The most likely outcome, unfortunately, is that Washington and the Fed will continue to do what they've been doing for decades - waiting and hoping that the day of reckoning holds off until someone else is in office.

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