Spinnaker Report

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July 2015

AHW &Co Quarterly Commentary
July 2015

The return of volatility was a focal point of our last newsletter. Without question, the 2nd quarter of 2015 has lived up to that theme. European quantitative easing and bond purchases had been driving global rates to near zero or in some cases actually negative. In late April this trend ceased and began to unravel with the German 10 yr Bund yield rising from .07% to over .80%, a move of over 70 basis points. US Treasury yields rose proportionally in sympathy creating significant headwinds for fixed income products. Municipal bond issuance which had been limited during much of 2014 and early 2015 increased dramatically as state and local governments rushed to refinance outstanding debt. As of June 11, $197.3 Billion has been issued year to date, up 50.4% compared to this period last year according to Bank of America research. These two factors at work simultaneously have pressured the municipal bond asset class and have caused underperformance versus taxable alternatives.

The markets are navigating several cross currents. The question of when the Federal Reserve will lift short term rates (and how much over what time frame) in the attempt to normalize policy will continue to be a constant variable. The continuing saga of a Greek bailout by the European Union provides a consistent and periodic uncertainty.

Since there are no historical comparisons, unwinding of quantitative easing is impossible to predict. References have been made about a “new normal” which probably best describes how this will all play out. Even with our decades of experience trading interest rate instruments, we don’t attempt to predict the future, although we can make some calculated assessments. In our opinion, the bond market has in fact already tightened in front of the Fed. The US Treasury 10yr at 2.35% is valued fairly in anticipation of 25 basis point rise in the Federal Funds rate. The slope of the yield curve given inflation expectations is actually steeper which makes longer maturities a bit cheaper than expected.

Investors looking for answers on where to allocate assets face some difficult choices. As stated, predicting interest rates is nearly impossible and cash will continue to earn nominal interest in the foreseeable future. Equity markets have provided solid rates of return over the last several years but elevated evaluations are becoming a cause of concern. Objectively, the selection of tax free securities is extremely compelling. We state this not to be self serving, but based on several observations:

Continued on next page

- Taxable equivalent – A municipal bond yielding 3.25% to a 10 year call equals approximately 6% for a taxable security at the highest Federal tax rate. Investors in high income tax states NJ, NY, CT, CA, NC can receive additional tax free income that produce taxable equivalent yields in excess of 6.75%.
- Municipal supply- If interest rates increase the economics of refinancing outstanding debt are not as advantageous and it can be assumed that tax free bond issuance will decline.
- Tax free demand- June to August 2015 will be a record year for cash flow with approximately $150 Billion being returned to investors via coupon interest payments, bonds maturing and bonds being called (see table on next page).
- Elevated yields – Historically tax free interest rates have yielded less than their taxable counterparts. Presently, 10 yr AA rated municipal bonds yield 109% and 30 yr AAA bonds yield 108% of similar rated taxable bonds.
- Return of Federal subsidies- Bills have been introduced in Congress to reintroduce Federally subsidized taxable municipal bonds. Build America Bonds (BABs) were created to expand infrastructure investments by state and local governments in February 2009 and expired December 31, 2010. Should a similar alternative surface, the supply of tax free securities would diminish as existing bonds mature and new issue volumes decrease.

The combination of these factors should provide tax free securities with advantages. It can be anticipated that tax exempt securities outperform in the future.
We have begun adjusting our management strategies in preparation for expected short term rate increases. Last fall we reduced average leverage by 20%. Our plan is to reduce it again in mid July. This action is designed to shrink the size of core holdings to decrease potential head winds associated with daily and weekly market to market portfolio valuations. We have been aggressive in employing more short term trading. During periods of high supply and issuance municipal bonds traditionally trade at greater spreads, which permits higher average mark ups which we use to enhance trade profitability.

In the last couple days, Puerto Rico has become a focal point much like Greece. Over the last couple years we have trimmed our exposure to PR bonds to a very minor level. The majority of our holdings are bonds that are insured by Assured Guarantee which carry a S&P AA /stable rating or National Re, a subsidiary of MBIA Inc., which carries a S&P AA- /stable rating. Both of these insurance companies have been stress tested to include their ability to withstand a PR default scenario. We are confident that these portfolio holdings are sound investments although we anticipate current pricing by custodians to show declines in sympathy to similar uninsured debt.
In conclusion, while we cannot completely avoid market headwinds, we can and do mitigate the effects through our proprietary trading and active management strategies. We firmly believe our risk versus reward methodology will continue to be successful in the future.

Thank you all again for your continuing support.

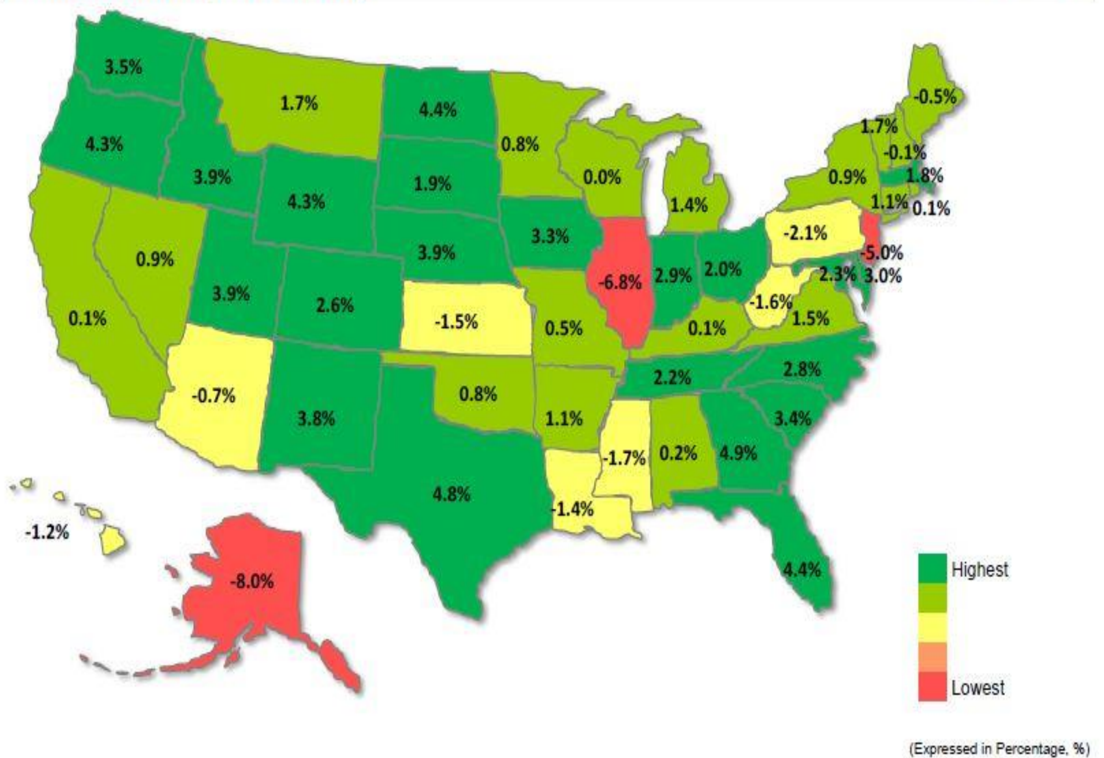
Tax free demand- June to August 2015 will be a record year for cash flow with approximately $150 Billion being returned to investors via coupon interest payments, bonds maturing and bonds being called
(see table).

- Cash flowing back to customers- June to end of August (CALLS IN JULY & AUGUST JUST STARTING)
  Data represents: Calls/Maturing & Coupons (TAX FREE)
- Notes/VRD/ARS/Student loans are not part of these statistics
- 2012- $145,564,177,000 (tax free supply- $99,125,654,000
- *2015 $141,050,222,000 (tax free supply- TBD
- 2013 $138,709,902,000 (tax free supply- $73,106,429,000
- 2014 $133,495,884,000 (tax free supply- $86,278,086,000
- 2007 $127,646,515,000 (tax free supply- $80,719,750,000
- 2011 $124,550,347,000 (tax free supply- $73,703,648,000
- 2010 $115,266,494,000 (tax free supply- $69,488,607,000 (BAB's)
- 2006 $111,547,936,000 (tax free supply- $68,575,218,000
- 2008 $108,962,017,000 (tax free supply- $81,096,415,000
- 2009 $105,082,803,000 (tax free supply- $87,967,045,000 (BAB's)
-
- * 2015 will end up with the largest amount of cash flowing back to investors during this 3 month cycle... Our projection is for cash to come in at a MINIMUM of $148 Billion on a VERY CONSERVATIVE estimate with a $153 Billion being the wide side. We think it comes in at the $150 Billion range which will make 2015 a new record.
-
- Calls so far total $29,876,235,000 for the 3 months... but July and August calls just starting. Will easily be closer to $42-45 Billion.
-
- Coupon interest for 3 months is- $32,287,575,000
- Bonds maturing totals for these 3 months is- $76,518,457,000

Source: Siebert Branford & Co

Despite the headlines, credit quality remains high for most of the municipal bond market.

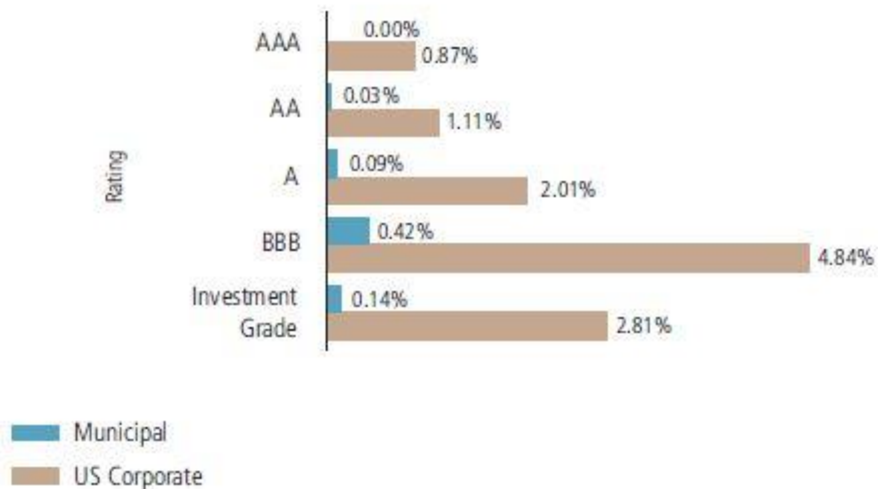
Financial Strength Heat Map As of 5/29/2015



Source: BMO Capital Markets

Fig. 3: S&P 10-year default rates of munis vs. corporates

In %



Source: S&P, 2014 Annual US Public Finance Default Study and Rating Transitions, 5 May 2015, and Annual US Corporate Default Study and Rating Transitions, 12 May 2015, UBS CIO WMR

- S&P Affirms Assured Guaranty's AA Financial Strength Ratings with Stable Outlook
- 2015-07-06 14:34:00.135 GMT

New Report Highlights Assured Guaranty's Very Strong Capital and the Proven Track Record of Its Well-Established Business Model

Business Wire

- HAMILTON, Bermuda -- July 6, 2015
- In a June 29 rating report on Assured Guaranty Ltd. (NYSE:AGO) and its operating subsidiaries (collectively, Assured Guaranty), Standard & Poor's Ratings Services (S&P) affirmed the AA Stable Outlook financial strength ratings of U.S. bond insurers Assured Guaranty Municipal Corp. (AGM), Municipal Assurance Corp. (MAC) and Assured Guaranty Corp. (AGC); European financial guarantor Assured Guaranty (Europe) Ltd. (AGE); and reinsurer Assured Guaranty Re Ltd. (AG Re). The AA rating is the highest S&P currently assigns to any financial guarantor.
- In the report, S&P noted Assured Guaranty's:
- * Very strong capital adequacy
- * Strong competitive position, built on a proven track record of credit
- discipline and market leadership
- * Strong operating performance as a result, in part, of the long-term
- earnings power of the U.S. public finance business
- * Strong liquidity, with conservative investment strategy
- * Strong, well-diversified underwriting strategy, with a global footprint
- and low country risk
- * Strong enterprise risk management
- * Strong understanding of the various risks the company faces by an
- experienced management team
- In response to the report, Dominic Frederico, President and CEO said:
- "The S&P report highlights our capital strength, disciplined risk management, strategic flexibility and market leadership. Specifically, based on our understanding of S&P's capital adequacy model, we estimate that Assured Guaranty had $1.9 billion of capital in excess of the AAA requirement at year-end 2014. This is $400 million higher than the approximately $1.5 billion at year-end 2013 that S&P reported in its July 2, 2014 ratings report.
- Additionally, we continue to demonstrate our market leadership – we guaranteed approximately 64% of the insured U.S. municipal par that came to market in the second quarter of 2015.
- "We have a proven and trusted business model and provide outstanding market liquidity for investors in our insured municipal bonds, which have $400 million of daily trading volume. Our multiple underwriting platforms support strong operating performance by allowing us to serve a range of markets and investor segments. And with our $12 billion in claims-paying resources, and approximately $400 million in annual income from investments alone, we are well positioned to support small, medium and large transactions."
- With regard to Assured Guaranty's Puerto Rico exposure, S&P considered the effect of "a default by multiple issuers in Puerto Rico over a one, two, or three year time period" and concluded there would be no change in Assured Guaranty's capital adequacy score based solely on such defaults. S&P noted that if Assured Guaranty pays any claims, the payments would be made over time based on each insured issue's payment schedule.

  "S&P has taken a hard look at all of our exposures, including those in Puerto Rico, and reiterated that the outlook for our AA ratings is stable," said Mr. Frederico.

- The Inevitable Selloff in Treasuries Is Greatly Exaggerated 2015-07-06 08:26:50.175 GMT
- By Daniel Kruger
- (Bloomberg) -- Don't count out Treasuries just yet.
- Even after the prospect of higher U.S. interest rates sparked the deepest selloff in two years, Prudential Financial Inc., RBC Global Asset Management and ED&F Man Capital Markets say there are still plenty of reasons to keep government bonds in demand. From worries over Greece's financial ruin to the sudden collapse of China's stock market, events halfway around the world are prompting traders to question whether the Federal Reserve will start raising borrowing costs before year-end. Deutsche Bank AG, one of the 22 primary dealers that trade directly with the Fed, now expects the central bank to hold off until 2016. And it isn't just global shocks that may support Treasuries. While jobs are back and business confidence is growing, wages remain stagnant. That suggests the weakest expansion in the post-World War II era is still struggling to generate the kind of inflation that causes investors to abandon U.S. bonds. What's more, the last time that 10-year notes were so cheap relative to short-term debt -- in September -- they rallied during the next three months. "There's a good chance yields are going to crest here," Robert Tipp, chief investment strategist in Prudential Financial's fixed-income unit, which oversees $560 billion, said from Newark, New Jersey. Since reaching a peak of 2.50 percent in June, yields on 10-year Treasuries have retreated and ended at 2.38 percent on Thursday. U.S. financial markets were closed on July 3 to celebrate the Fourth of July holiday. The yield fell eight basis points, or 0.08 percentage point, on Monday to 2.31 percent as of 9:24 a.m. in London.

- Tantrum Redux
- Signs of renewed demand come after Treasuries tumbled 2 percent last quarter, index data compiled by Bloomberg show. The slump was the biggest since the three months ended June 2013, after then-Fed Chairman Ben S. Bernanke sparked the "taper tantrum" by suggesting the central bank may end its bond-buying program. The selloff, part of a global rout in bonds, gained momentum in the past month as reports on labor growth to personal spending indicated the U.S. economy was on an upswing, strengthening the Fed's case for finally raising rates after leaving them close to zero since 2008. Tipp says that's made longer-term Treasuries more attractive. Based on a metric known as the "term premium," 10- year Treasuries offer 0.5 percentage points more in yield than short-term debt. The last time that happened, the notes returned 3.6 percent in the next three months in the biggest quarterly advance since 2012.

- Capital Flight
- Global events are also putting a premium on safety and delaying the exodus from Treasuries that almost everyone on Wall Street predicted would be inevitable. In Europe, the crisis in Greece escalated the nation missed a $1.7 billion payment to the International Monetary Fund and voters rejected further austerity measures demanded by creditors, heightening concern a financial collapse may fracture the euro bloc and spark capital flight from the region. Investors will start to focus on "what's the next Greece," Brandon Swensen, the co-head of U.S. fixed income at RBC Global Asset, which oversees $35 billion, said from Minneapolis. "Any event that catches the market off-guard, it's very predictable that Treasuries are going to rally."

- China Bubble
- The bursting of China's stock bubble is also deepening concern about the health of emerging markets, after investors there lost more than $3 trillion in three weeks. While America remains the bright spot, the potential knock- on effects of higher U.S. rates on the global economy have already prompted both the World Bank and the IMF to call on the Fed to delay any increases until 2016. Traders are signaling the Fed will heed their advice. Based on Morgan Stanley's analysis of futures trading, the first rate increase won't occur until January. In March, the market was anticipating a September rate rise.
- "Given all the uncertainty, this makes it harder for investors to feel confident" about the economy, said Gary Pollack, who manages $12 billion as head of fixed-income trading at Deutsche Bank AG's private wealth unit in New York. "The safest place to be in these uncertain times is the safety of Treasuries."

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- Wages Unchanged
- The latest labor reports indicate that even in the U.S., the economy remains on uneven footing, giving the Fed room to stay patient. Although employers hired more workers in June, average hourly wages were unchanged at $24.95 an hour from the prior month, a Labor Department report showed July 2. And the lack of wage pressure is one reason why inflation remains almost non-existent.
- Annual consumer prices have fallen or remained flat every month this year, and bond traders expect inflation will stay well below the Fed's own 2 percent target through the end of the decade, data compiled by Bloomberg show.
- "The two things that matter most as far as the timing of liftoff is concerned are wage growth and inflation, and right now we don't have either," said Ward McCarthy, chief financial economist at Jefferies Group LLC in New York.
- The risk, of course, is that investors in Treasuries underestimate the willingness of Fed officials to raise borrowing costs as they anticipate a strengthening economy and faster inflation. On June 30, Fed Bank of St. Louis President James Bullard said while Greece's potential meltdown would spur demand for Treasuries, it's unlikely to sway policy makers.

- September Possible

- "It would not change the timing of any rate hike," he said. "I would say September is very much still in play."
- In June, Fed officials maintained their year-end forecast for its benchmark rate at 0.625 percent, which implies two quarter-point increases by December.
- With inflation so low, the Fed's fixation on raising rates from rock-bottom levels may actually squelch growth and prematurely cut short any upswing. That may ultimately boost demand for Treasuries, according to Prudential's Tipp.
- "I don't think they can be that myopic and say they can tighten with all that's going on," Thomas di Galoma, the head of fixed-income rates and credit at ED&F Man, said from New York. "We've seen the highs for the year" in yields.

- Munis’ Rare June Fund Exodus Compounds Worst Quarter Since 2013
- 2015-06-09 04:01:00.8 GMT
- By Brian Chappatta
- (Bloomberg) -- This is normally a time of year when the individuals who own the majority of municipal debt collect coupon and principal payments and direct the cash back into the market. This year, they appear to be taking their money elsewhere. Assets in muni mutual funds fell by $381 million in the week through June 3, the fifth-straight outflow, according to Lipper US Fund Flows data. It was only the second time in a decade that the funds have shrunk at the start of June, in part because it coincides with a period when investors get paid from maturing debt and interest. Taxable funds pulled in about $1.2 billion.
- The exodus signals weakening demand in a market dominated by investors who tend to buy bonds, hold them to maturity and roll them over into new securities. Tax-exempt debt has lost 1.5 percent since March 31, Bank of America Merrill Lynch data show. It’s on pace for the largest quarterly drop since the same period of 2013, when Detroit’s move toward bankruptcy and speculation that the Federal Reserve was close to paring its bond-buying prompted unprecedented withdrawals. “You would expect to see a better top-line number for the first week of June,” said Chris Mauro, head of muni strategy at RBC Capital Markets in New York.

- Individuals’ Sway
- Individuals own about 60 percent of munis either through specific bonds or mutual funds, giving them outsized sway over the market’s performance. The latest withdrawals, the largest since tax-related outflows in the week through April 15, were surprising because of the estimated $35 billion bondholders are set to receive, Mauro said. This month’s payments will probably be the year’s third- highest, behind July’s $44 billion and August’s $38 billion, he said. Munis are joining a selloff in global bonds as signs of economic strength fuel bets the Fed will raise borrowing costs as soon as September. The recent fund outflows aren’t as severe as the $1 billion or more seen almost weekly during the 2013 fixed-income rout dubbed the “taper tantrum.”

- ‘Added Burden’
- “Muni price volatility is first and foremost a function of Treasury volatility, but we have the added burden of facing some outflows,” said David Manges, manager of municipal trading at BNY Mellon Capital Markets LLC in Pittsburgh. The deteriorating finances of issuers including Puerto Rico, New Jersey and Chicago have also dimmed the appetite of some bond buyers, said Alan Schankel, managing director of fixed-income strategy at Janney Montgomery Scott LLC in Philadelphia. Benchmark 10-year muni yields climbed to 2.37 percent Monday, the highest since July 2014, according to data compiled by Bloomberg.
- Demand for tax-free income is shielding munis from the worst of the global bond losses. Their quarterly decline is more muted than losses of 2.3 percent for Treasuries and 2.7 percent for investment-grade corporate debt, Bank of America data show. “In the total fixed-income world, munis have more appeal than other sectors mostly because of high tax rates and their high after-tax returns,” Schankel said. Yet even amid the stretch of fixed-income declines, investors have poured money into funds focused on taxable bonds, adding $15.4 billion over the last eight weeks, Investment Company Institute data show. “Hopefully this is not like 2013, where the outflows become more substantial,” said Manges at BNY Mellon.

1650 Market Street
53rd Floor
Philadelphia, Pa 19103
215-569-9800
www.ahwilliamsco.com

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