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What a difference a year makes! We are now at the halfway point of 2014 and the equilibrium of supply and demand is again at an imbalance. Over $100 billion dollars worth of municipal bond proceeds will have become available from June through August. Unlike last summer when investors became spooked by prospect of the Fed ceasing quantitave easing and rising interest rates, just the opposite is occurring. What has happened since is a classic “sell the rumor, buy the news” rally that began last fall and has strengthened especially this past quarter. The April tax filing deadline which typically softens the market did nothing to diminish the increasing appetite for tax advantaged investments. If anything, investors seemed surprised by the effects of the higher marginal tax rates, and changes to the tax laws, even though they had been well publicized for over a year. Mutual funds have seen inflows in 20 of 26 weeks this year after a record wave of withdrawals in 2013 according to Lipper US Fund Flows data. Although the spread relationship of tax free bonds to their taxable counterparts has continued to tighten, the 2.4% yield on 10 year benchmark muni’s is equivalent to a taxable interest rate of 4.24%. By comparison, Treasuries maturing in 10 years yield approximately 2.6%.

Municipal bonds are not the only market experiencing supply issues. Taxable bonds have also witnessed a period of shortages even in the face of the Federal Reserve tapering bond purchases each month. There is talk of a “new neutral” in which rates remain historically low for a long time. For the time being there is a strong underlying bid beneath the market that defies forecasting. The desire for fixed income is not limited to just US Dollar denominated investments. European debt is experiencing historically low yields with Spain and France sovereign debt trading at levels not seen in over a century.

We concluded our last newsletter with the anticipation of continuing the positive trajectory experienced in Spinnaker portfolios over the prior several quarters, while maintaining a bias towards a defensive posture. Although our market call did not predict the magnitude of market strength experienced in Q2, our active trading strategy provided many opportunities which translated into excellent performance results in all Spinnaker portfolios.

Leading into the heavy July and August reinvestment period, our approach is to add selectively and increase portfolio size while the supply of new issues is the heaviest, currently approximately $9 billion. The bulge in supply reached a 2014 peak on 6/4/14 when $15 billion bonds were slated for sale. Conversely, the low in supply occurred on 5/1/14 with $4.09 billion for sale. We believe that any pause in the upward momentum experienced during June to be temporary and represents a short term trading opportunity. The beginning of July provides several weeks of holiday vacations and supply shortages are probable.

Looking forward, it is our intent to maintain a defensive core position and operate with below average daily leverage characteristics. At the same time we will continue to seek and execute short term trading opportunities as presented.

Municipal Bonds Enjoy a Resurgence

THE WALL STREET JOURNAL

By Aaron Kuriloff

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Municipal-bond prices have come roaring back, reversing last year's rout despite enduring financial challenges facing U.S. cities and states. The resurgence in the $3.7 trillion market comes as bond buyers attempt to find higher investment returns amid a tumble in U.S. interest rates.

Long coveted by mom-and-pop investors for their tax benefits and relative stability, municipal bonds—debt sold by cities, states and local government-related entities—are benefiting from a broad bond-market rally and a decline in new debt being issued by municipalities that are still trying to tighten their belts. The municipal-bond market posted its worst year in 2013 in almost two decades, registering losses in the wake of Detroit's record municipal bankruptcy-protection filing, concerns over hefty pension costs in Illinois and economic worries in Puerto Rico.

Investors have poured $3.1 billion into municipal-bond mutual funds this year, compared with $2.96 billion over the same period in 2013, according to data from Lipper as of Wednesday. The gains mark a shift after investors pulled $39.9 billion from the funds in the last 31 weeks of 2013, the data show. Yields on municipal debt fell to 2.325% on Wednesday, according to Barclays PLC, their lowest in almost a year. Yields fall when prices rise.

The gains have made the debt a star performer for investors this year, in a twist few predicted. Municipal bonds have returned 5.869% in 2014, reflecting interest payments and price appreciation. That compares with total returns of 5.769% on highly rated corporate bonds, 3.3% for the S&P 500 and 2.982% on U.S. Treasury debt, according to Barclays data. "I don't think the need for tax-exempt income ever went away, and there appears to be pent-up demand," said John Miller, co-head of fixed income at Nuveen Asset Management LLC, which oversees about $90 billion in municipal bonds.

Cities and states aren't borrowing enough to meet the demand from investors, said Vikram Rai, a fixed-income strategist at Citigroup Inc., which forecasts issuance will fall to $280 billion this year, from $334 billion in 2013. "The primary market supply is very anemic and that's really driving down yields," he said. Many municipal bonds are still considered nearly as safe as Treasurys, because they are backed by the taxing authority of various governments. Their prices typically move in tandem with the U.S. government-debt market, and this year, Treasury bond prices have staged a surprising rally. The riskiest municipal bonds are rallying the most, though many brokers and investment advisers still are steering retirees and other individual investors away from junk-rated municipal bonds, as their clients are looking for stable income and savings. These buyers generally "are looking for the safety that muni bonds have and shy away from those municipalities that have lower credit ratings or are in trouble," said Benjamin Chuckrow, a senior vice president with Wells Fargo Advisors in Saratoga Springs, N.Y.

He warns clients interested in municipal debt that there are two types of risks to consider: whether the issuer is in good financial health and what may happen to the bond's value between now and when it matures. If interest rates rise before the bond matures, investors who want to sell beforehand could get lower prices. To be sure, some state and local governments are struggling to mend their finances amid anemic U.S. economic growth. Many have cut their budgets and plugged pension gaps.

Puerto Rico is attempting to recover after its debt was downgraded to junk in February, but the bonds' prices have risen since the U.S. territory sold $3.5 billion of debt in March. One Puerto Rico general obligation bond traded at 71.5 cents to the dollar this week, up from 63.75 in December. The S&P Municipal Bond Puerto Rico Index has returned 10.6% this year through Wednesday.

In comparison, high-yield municipal bonds have returned 9.33% this year, Barclays said.

Illinois, which has struggled to address its underfunded pension, in February sold $1 billion in general obligation bonds, paying less to borrow than the state did eight months earlier. The new deal came as lawmakers reached an agreement that would close the pension gap by about $100 billion.

"State and local governments were in a severe squeeze following the housing downturn and the deep recession," said Dean Maki, chief U.S. economist at Barclays. "Now, that is stabilizing."

Rising federal tax rates also have brought investors back to tax-exempt municipal debt, said George Rusnak, managing director of global fixed income at Wells Fargo Private Bank. "You're seeing individuals have stronger demand for tax-free income," he said.