ASSET PRESERVATION ADVISORS

1Q 2015: A Volatile Start To The Year

A Stronger Dollar and Declining Global Yields Disrupts Markets

The first quarter of 2015 sent shockwaves through financial markets worldwide. Global currency and interest rate volatility spiked in response to a confluence of factors; most notably, the ongoing uncertainty surrounding the timing and magnitude of the Fed "lift-off", a stronger U.S. dollar, falling oil prices, geopolitical tensions, and the launch of the European Central Bank (ECB)'s quantitative easing program.

Declining interest rates around the world contributed to strong returns among fixed-income securities during the quarter. The start of the ECB's quantitative easing program in early March helped drive Eurozone yields not only to record lows, but even into negative territory in some cases. The yield on a 10-year bond recently issued by Switzerland was -0.055%. This all-time low global interest rate environment helped drive up demand in U.S. fixed-income markets. After a temporary move higher in February, interest rates ended the quarter lower following the Fed's downward revision to both growth and inflation projections at the March FOMC meeting. 1Q15 marks the fifth consecutive quarter that the yield on the 10 year Treasury Note has moved lower, dropping to 1.94%.

Many market analysts attribute the recent weak economic performance and sluggish growth to the strengthening of the U.S. dollar. The impacts of a stronger dollar are far-reaching; as consumer goods made in the U.S. have become more expensive, we have witnessed a decline in U.S. export activity along with a deceleration in the manufacturing sector that has resulted in slower job growth. Many forecasters have lowered their earnings expectations for the remainder of 2015, predicting weaker GDP growth and citing that a stronger dollar will negatively affect the profits of multinational companies that rely heavily on foreign trade. Falling oil prices have had both negative and positive impacts on the market, triggering thousands of energy-related job cuts and a decline in energy and oil-related investment profits, while also leading to an increase in disposable income as a result of savings at the pump.

After Fed Chairwoman Janet Yellen set a more dovish tone regarding the timing and pace of future interest rate hikes at the March FOMC meeting, there appears be more of a consensus amongst market analysts that a sharp spike in rates during the first half of this year is highly unlikely. APA maintains our prediction that the initial Fed "lift-off" will likely not occur until the end of the year, *at the earliest,* and will involve a gradual increase in rates.

Municipals posted modest gains in 1Q15, as continued investor demand, a flattening curve and a decline in yields helped offset an increase in quarterly issuance.

Duration Drives Muni Bond Performance

Municipal bonds were able to overcome both a surge in supply and looming interest rate hikes to post modest gains in the first quarter of 2015. Performance was driven largely by duration, with longer bonds outperforming as rates fell and the yield curve continued to flatten. Municipal issuance totaled $105.4 billion for the quarter, marking a year over year increase of 63.4%, according to Barclays data. The significant increase in supply did not weigh heavily on overall market performance though, as refunding activity accounted for approximately 71% of total issuance and new money issuance actually trailed last year's levels by roughly 3.5%.

A surge in issuance in the intermediate maturity range did, however, cause a slight anomaly in the overall flattening of the yield curve. As seen in the chart below, the 15 to 20 year part of the curve experienced a significant rise in yields, largely as a result of consistent refunding supply pressure that was concentrated in this maturity range. This led the 15 to 20 year part of the curve to underperform during the first quarter of the year, seen when comparing the total returns of the Barclays municipal indices. The Barclays 10 Year Index returned 1.26% for the quarter, while the Barclays 15 Year and 20 Year Indices' underperformed with total returns of 0.87% and 1.00%, respectively. Longer bonds in the 22+ maturity range posted the highest quarterly return of 1.58%.

Date	1-yr	3-yr	5-yr	7-yr	10-yr	12-yr	15-yr	20-yr	30-yr
12/31/14	0.16	0.78	1.32	1.69	2.04	2.18	2.33	2.58	2.86
3/31/15	0.19	0.82	1.24	1.60	1.96	2.18	2.45	2.67	2.80
Change in bps	+3	+4	-8	-9	-8	0	+12	+9	-6

Source: Thomson Reuters MMD

In This Issue

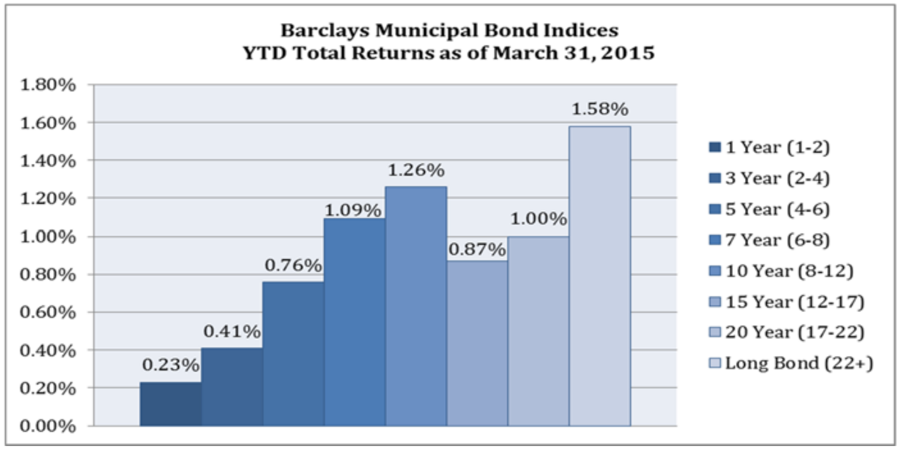
Muni Credit Spotlight

California Drought

The State of California remains under a severe drought for the fourth consecutive year, pushing the state's water resources to a critical level. Governor Jerry Brown recently ordered a statewide 25% reduction on residential water usage. In April, Moody's published a report stating that this water conservation measure is a "credit negative" due to potentially lower revenues. We note in November Moody's issued a report stating that "drought conditions and water conservation measures will not seriously impact the credit quality of California water and sewer utilities, at least through 2016." Positively, the California Water/ Sewer Systems that APA owns have healthy financial medians with debt service coverage of 1.9x and liquidity of 577 days cash on hand compared to the Merritt Water/Sewer medians of 2.1x and 177. While we believe that these systems are well positioned to deal with prolonged drought conditions, we continue to remain highly selective on California utilities.

Chicago

Second term and recently reelected Chicago Mayor Rahm Emanuel has his work cut out for him to strengthen the city's finances and pension systems. In February 2015, Moody's Investors Service downgraded the city one notch to Baa2 with a negative outlook due to growing pension problems. The city's increasing pension liabilities hinge on a state formula for statutory contributions, which are tied to payrolls instead of a growth in benefits. As a result, the gap between actual contributions and actuarially determined contributions ballooned to over $1 billion in fiscal 2013. Chicago's growing pension problems may lead to further downgrades, which could rapidly exacerbate the city's budget problems as outstanding swaps, LOCs, commercial paper programs, and line of credit agreements include downgrades as termination events or events of default. The downgrade already triggered $58mm in termination payments. Any additional downgrades to below Baa2 or BBB would trigger another $39mm payment. While these payments could easily be absorbed by current operating cash, any potential payments required should the city be downgraded below Baa3 or BBB- would skyrocket to roughly $1.6bn, double the $805mm in cash currently held in operating funds.



Source: Barclays Research

Over the quarter, continued strong investor demand supported the municipal market and was able to match the substantial increase in supply. Municipal/Treasury ratios remain attractive and continue to entice crossover buyers, thus bolstering overall demand. The relative value municipals offer is most pronounced at the long end of the curve, where ratios are around 110%. One reason for the attractive ratios is that heavier volume of issuance tempered a rally in muni bond prices compared to Treasuries over the quarter, which enjoyed increased global investor demand as a result of declining interest rates in Europe and Japan.

	AAA Muni	Treasury Gross	M/T Ratio
1 year	0.19	0.22	86.4%
5 year	1.24	1.38	89.9%
10 year	1.96	1.93	101.6%
15 year	2.45	2.24	109.4%
20 year	2.67	2.39	111.7%
30 year	2.80	2.54	110.2%

Source: Thomson Reuters MMD

Municipal bonds become even more compelling when comparing their taxable equivalent yields, as indicated by the following chart that reflects a tax rate of 39.6% plus the new "Obamacare" 3.8% Net Investment Income Tax.

	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
AAA	0.49	0.82	1.24	1.60	1.96	2.67	2.80
AAA Taxable Equivalent Yield	0.87	1.45	2.19	2.83	3.46	4.72	4.95
AA	0.56	0.93	1.39	1.79	2.19	2.91	3.04
AA Taxable Equivalent Yield	0.99	1.64	2.46	3.16	3.87	5.14	5.37
A	0.69	1.06	1.58	2.06	2.48	3.25	3.38
A Taxable Equivalent Yield	1.22	1.87	2.79	3.64	4.38	5.74	5.97
Baa	1.25	1.62	2.08	2.51	2.89	3.63	3.76
Baa Taxable Equivalent Yield	2.21	2.86	3.67	4.43	5.11	6.41	6.64

Looking forward, APA believes market volatility is likely to continue due to the ongoing uncertainty of the global economy. We continue to employ a barbell investment approach, emphasizing both the 0-2 year and 9-13 year parts of the curve. APA currently sees opportunity in short-duration, higher coupon bonds, as we feel they have the potential to be pre-refunded and therefore could appreciate in value. Even though credit spreads have compressed and are now close to their average historical ranges, APA is selectively seeking out value in smaller A-rated issuers that may be inefficiently priced and overlooked in the secondary market.

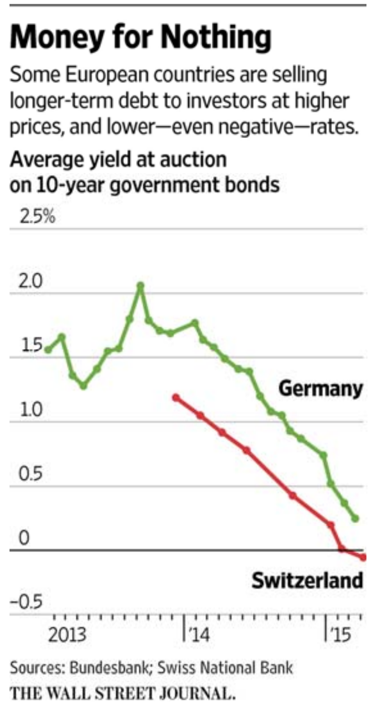
Final Thoughts

by Ken Woods

"Out of the Woods"

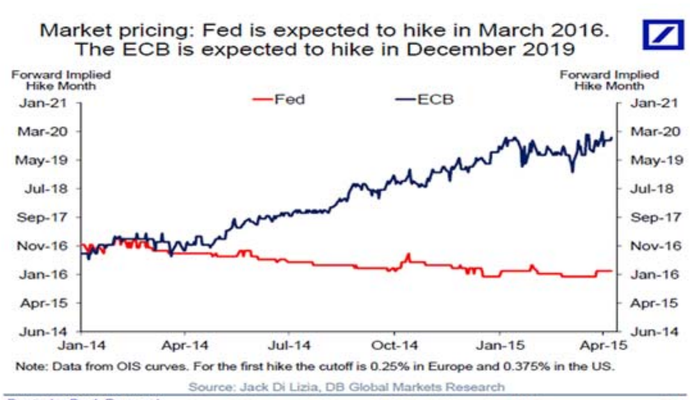
How Low Can They Go?

I think the big mistake for interest rate forecasters over the last few years was not only did they get the direction wrong, rates went down and not up, but, to their dismay, some rates have gone negative. The U.S. had negative interest rates (T-Bills) in the 1930's at the depth of the depression, but very briefly.



According to the Wall Street Journal, Switzerland recently sold a total of 377.9 million Swiss francs (about $391 million) of bonds maturing in 2025 and 2049.The 10-year bond yield was minus 0.055%. That is not a misprint. If you bought the bond, you may lose 0.055% each year until it matures in 2025. German government bonds (bunds) have a negative yield out to eight years.

The obvious question is WHY? I can understand Swiss negative yields in that this maneuver could be a bet that the Swiss franc will continue to be strong, so it is like a long-term call on that currency. However, German bunds are payable in euros and in my view, do not make sense. Many economists would state that it is basic supply/demand causation, i.e., more money chasing a limited amount of quality investment. Many central banks throughout the world have been printing massive amounts of their currencies to combat the negative drag of the "Great Recession" and, in turn, fight against the deflation that began in 2008. Much of the liquidity they have created since then has been jammed up in the banking system and not put out into the economy in productive uses such as business loans. Central banks in Europe are charging as much as 75 bps for banks to park their money. According to The Federal Reserve, about $4 trillion in liquidity has been created since 2008, and our banking system currently has a record amount of free reserves, of over $3 trillion. In our recent Treasury Bond auctions, most of the buyers have been foreign buyers looking again for a safe place to park their money. As a matter of fact, they bought 51.3 % of the 30 years auction on April 9th, which is just shy of the all time high of 53.2 %. This brings us to the other possibility of why I think rates are at historic lows: lack of confidence in our policy makers and their central banks. World central banks are in truly uncharted waters. In today's world economic environment, i.e. prodigious amount of liquidity, low inflation (and in some places deflation), anemic world growth, and a strong dollar, how will the Federal Reserve raise short term rates? In my opinion, the answer is that they cannot, at least not until 2016.



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