## 3Q 2015: One Quarter, Two Halves

The Third Quarter of 2015 may be remembered as the three months where volatility returned, and returned with a vengeance; and where the Federal Open Market Committee (FOMC) added even more uncertainty to an already murky policy.

What looked to be another period of low volatility, with the S&P 500 continuing to trade between its months' long band of 2,050-2,125, and the market patiently awaiting a confidence boost from the Fed regarding the economy, instead took a nasty turn in the middle of August as the People's Bank of China (PBOC) devalued the Yuan by the most in two decades, sending shockwaves across world markets. Although the bank did its best to reassure market participants that this was a one-time adjustment and that going forward the currency would be allowed move with natural supply and demand, markets saw this as a warning of the Chinese economy slowing greater than previously anticipated and braced for the worst, sending commodities down a steep slide, treasury rates diving, and volatility across global equity markets soaring.

During the period of August 17 through August 25, the S&P went from 2,102 down to 1,867 (-12%), the Dow from 17,545 to 15,666 (-11%), the 10YR treasury yield from a 2.20% to a low of 1.97%, and the volatility index (VIX) from a boring 12.83 to a roaring 40.74. Many market participants have been waiting for a natural correction like this for some time, as a big downward move in the equity markets is years overdue, but the reasons behind the recent flight to quality is still leaving investors with a feeling of fear we have not seen since 2008.

As much as the FOMC seemed to want to raise the Federal Funds rate off the 0 - .25% range, and as much as they tried to talk the market into believing they were going to do so in September, they have found out that raising rates is extremely difficult when the rest of the world, and possibly the US, is stuck on hold or even contemplating further easing policy. Not only did the Fed balk on a September raise, matching our in-house view, they complemented the move with their most dovish statement in sometime. The September statement was the first to acknowledge that outside factors (ie China) could play an increasing role in the domestic economy, potentially causing further slowdown. Couple this with continued pressure on commodity prices and wage growth, and we believe there is little reason to assume the Fed will see their 2.00% inflation goal anytime soon. Janet Yellen and her team quickly tried to keep a 2015 hike in the picture, but we believe a December liftoff remains 50/50, at best, as the 2YR treasury yield fell from an anticipatory 0.85% the day before the Fed's release, down to 0.64% at the end of the quarter. This move was matched by 3 and 5YR treasury yields as well, which went from a 1.13% and a 1.62% to a 0.92% and1.37%, respectively. Furthermore, on September 28, the 5YR breakeven rate (the market's anticipation of inflation over the next five years) had its biggest daily drop in eight months, to a 0.99%, its lowest level in 6 years.

While we may see some psychological barriers due to the return of lower rates, when considering the moves in commodities, deeper global slowdown of growth, and a Fed that will most likely promise a gradual increase after their first move, we believe there is little reason to trust that this uneasy market will pass quickly. The 10YR treasury yield saw its biggest quarterly drop this year as investors pulled over $40 billion from developing economies, the fastest capital has flown from emerging markets since the last three months of 2008, the height of the financial crisis.

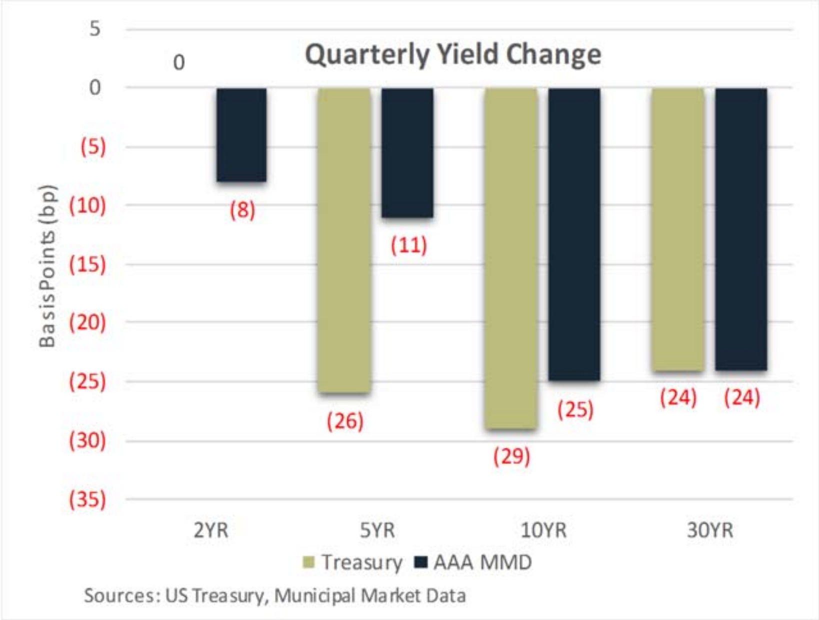
*A flattening yield curve, slight slowdown in supply and balk by the Federal Reserve helped municipal bonds post a strong quarter.*

### In This Issue

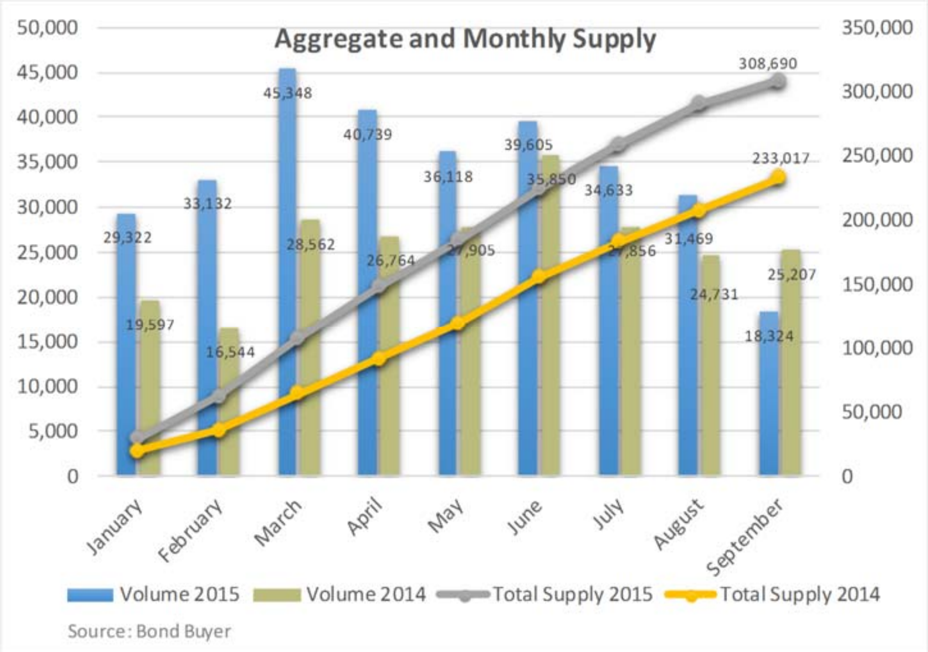

- 3rd quarter review
- Positive returns for municipals
- Muni credit updates: Puerto Rico and Chicago
- State and city revenues improve
- Final thoughts: fixed income allocation

## Muni Market's Response to the Noise

Municipals posted positive returns for the 3rd quarter as yields moved lower across the curve, albeit with interim periods of volatility. The muni curve followed treasuries in a flattening move, as the MMD 2s-30s spread tightened from 265 basis points to close the quarter at 249 basis points. For the period, the 2YR MMD yield tightened 7 basis points, outperforming the "policy sensitive" 2YR Treasury, which ended flat after a particularly volatile quarter as the market had seemingly priced in a Fed rate hike. As displayed in the chart to the right, the flattening move was led by the long end, as 10YR and 30YR MMD yields decreased 25 and 24 basis points, respectively. APA anticipates that as long as inflation remains benign, the curve will continue to flatten, and that this shift will be amplified if/when Fed deems it is the appropriate time to raise rates. We believe a flattening move should bode well for our barbell strategy.




Supply numbers continue to outpace 2014 (see below), driven by refunding deals as municipalities look to refinance outstanding debt. This pace slowed during the third quarter, which came in as the lowest quarter of issuance to date, while September closed as the lowest month of issuance for the year, roughly a third less than the previously low month of January. We expect this reprieve to be short lived, and supply to pick back up in the fourth quarter. State and local job growth remains robust, and in addition to refunding outstanding debt, we believe political leaders may finally look to invest in capital projects, especially given the low interest rate environment.



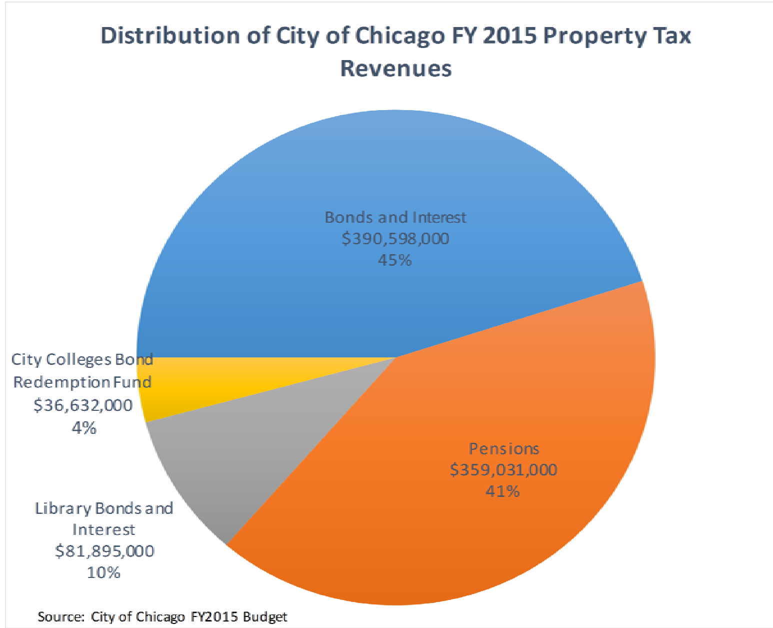

New money issuance is up a moderate 3.9% year to date. Past the immediate term, refunding deals have no effect on the total size of the market, which is up marginally for the year. The nominal increase in total supply has helped the market offset the recent period of outflows from bond funds that lingered throughout the quarter. However, the supply slowdown during the month of September, coupled with the first inflows into municipal mutual funds in five weeks, sent performance up on a strong note to end the quarter.

During the typical slow July and early August periods, we saw credit spreads slowly leaking wider as Puerto Rico, Illinois and Chicago continued to grab headlines. However, as the horizon clears up on all three of these issues and as rates drift lower, the reach for yield has caused spreads to tighten back to pre-summertime levels. That being said, we would not be surprised to see spread volatility return during periods of market weakness, especially if coupled with a heavier issuance calendar.

# APA Credit Spotlights

## Chicago: Will Tax Increases be enough to Solve Financial and Pension Problems?

On September 22, Chicago Mayor Rahm Emanuel released his 2016 budget to the city council. In order to prevent service reductions including staff cuts to the police and fire departments, as well as to fund the city's large pension obligations, Mayor Emanuel proposed various plans to increase revenue. These include a $543 million property tax hike spread out over four years as follows: $318 million in 2016, $109 million in 2017, $53 million in 2018 and $63 million in 2018. Homes valued at $250,000 or lower would be exempt from the tax increase. Other revenue enhancements include a special property tax for school improvements, a $9.50 monthly garbage pickup charge for households, new ride-share and taxi fees, and a tax on e-cigarettes. The mayor also proposed expense reduction by eliminating vacant positions, enacting tax increment financing (TIF) reform, and healthcare savings for current employees and retirees.




The city maintains four separate pension funds: The Municipal Employees Annuity and Benefit Fund; the Laborers' and Retirement Board Employees Annuity and Benefit Fund; the Police Annuity and Benefit Fund; and the Firemen's Annuity and benefit Fund. Under the mayor's proposal, a total of approximately $978 million will be contributed to these four pension funds, with $786 million coming from property taxes, and the remaining $192 million from other sources including city enterprise and special revenue funds. Of course, the budget must still be approved by the city council. APA believes the Mayor's 2016 budget shows a willingness to solve the city's pension and financial issues, yet also demonstrates his slight favoritism towards pensioners and uniformed servicers by funding these obligations through politically unpopular tax increases.

### Possible Methodology Change by Moody's Highlights Importance of Understanding Security

A recently proposed rating methodology change by Moody's, Loop Capital's special comments on various state general obligation (GO) pledges, Connecticut's Special Obligation Bonds Transportation Infrastructure Purposes bond deal and California's establishment of statutory liens on debt shines light on the importance of understanding the actual, underlying security. APA has always first evaluated the specific security backing a bond before making a recommendation to purchase.

Moody's Investors Service recently announced they are considering a change in their rating methodology on debt backed by leases, annual appropriations and moral obligations. According to *Bloomberg*, the change could affect the ratings of some 775 credits, or roughly 20-25 percent of Moody's municipal bond ratings. Investors can comment on the proposed changes until December 1. Loop Capital, in a series of special comments on state GO credits, still believes states have a lower risk of default. However, given some state's growing budgetary pressures, Loops states that "it is important for investors to understand the security backing these bonds, as the GO pledge varies significantly between states." For example, Louisiana's bonds are backed by the full faith and credit of the state with a first lien on revenues in the state's bonds security and redemption fund. New Jersey, a state on which APA has a negative

## Credit Update: Puerto Rico

APA continues to monitor Puerto Rico and the commonwealth's attempt at restructuring of its debt, narrow cash position and the underfunded pension fund. The Government Development Bank released an outline for how it plans to treat various securities during the restructuring. The government plans to begin negotiations with investors by mid-October. One positive for general obligation bondholders is that the GDB will "take into account the priorities of the debt that creditors hold." This would mean smaller losses for owners of the GO debt and emphasizes the increased importance of the underlying security.

Puerto Rico has another problem to confront: The government pension fund is expected to run out of money within four years. The pension, which covers over 119,000 employees, has an estimated $2 billion in payments next year and as of June 2014 only had roughly 0.7 percent of assets needed to pay all benefits. With reports stating Puerto Rico may run out of cash as soon as November, they may be forced to choose who to pay: bondholders, current government employees or retirees.

outlook, has a somewhat weaker security pledge as there is not direct lien placed upon receipts.

Connecticut, another state in which APA is highly selective from a credit perspective, came to the market with bonds secured not by the general obligation of the state, but by a gross pledge of motor fuels taxes, oil company taxes, general retail sales taxes, motor vehicle receipts, licenses, permits and fees, and sales taxes. The legal security structure includes a portion of sales taxes and is expected to provide over 2- times coverage. While we have generally stayed away from Connecticut State GO's due to weakened financial operations and long-term pension and OPEB liabilities, in our view this security pledge provides a greater level of bondholder security in the event of default through a dedicated gross receipts pledge.

California is another state that has clarified the definition of debt secured by a general obligation. On July 13, California Governor Jerry Brown signed into law a bill designating the security of the state's general obligation bonds issued by local municipal entities as "statutory liens." Similarly to Rhode Island, this new law provides clarity to GO bondholders as secured creditors in the event of a municipal bankruptcy. The law is an attempt to solidify the prioritization of GO bondholders, whose subordination to pension holders became apparent in recent bankruptcy cases such as Stockton and Detroit.

### State Tax Revenues Increased; Cities Financials Improved as well

According to two recently released publications, states and cities appear to be in better fiscal shape than in years past as overall state tax revenues have increased for the first quarter of 2015. City financial operations have also improved during the same time period. The Nelson Rockefeller Institute of Government, in a report published in September 2015, found state tax revenues increased in the first quarter of 2015, with preliminary results for the second quarter of 2015 showing further improvements. They report all major sources for states increased by 5.8 percent. Personal income taxes saw the largest increase at 7.1 percent, followed by sales taxes at 5.2 percent, motor fuel sales at 4.4 percent, and corporate income taxes at 3.3 percent. Total state tax collections for the first three quarters of fiscal 2015 increased 5.3 percent when compared to the same time period of 2014.

Cities have improved as well. In their annual City Fiscal Conditions report, The National League of Cities found 82 percent of U.S. Cities were better able to manage their fiscal priorities in 2015 than in 2014. This is the highest level in three decades. Reserves in cities are projected to reach 25.2 percent of their budgeted expenses in 2015 after many cities were forced to drawdown reserves because of recessionary pressures.

## Final Thoughts

**By Ken Woods**

Over the last several years, a great deal of investment discussion has been centered around the question of maintaining an allocation to fixed income when rates are stuck at historically low levels. We often hear investors say “surely interest rates have to go up from current levels?"

Recent stock market volatility has once again illustrated why an investment portfolio could benefit from having an allocation to fixed income. The below graph displays the returns on a 100% equity portfolio vs a typical 60/40 mix of stocks and bonds during the recent volatility. Generally speaking, there has been a slight negative correlation between the two asset classes, which is why an allocation to fixed income ***can*** be beneficial during significant down drafts in equity markets. Not only can the fixed income portion provide stability during these periods, but it can also potentially provide positive performance.

Modern Portfolio Theory (MPT) has been an investment process that most institutional investors use to guide them through periods of market disruptions, like the recent period of volatility.

There are four basic steps involved in portfolio construction:

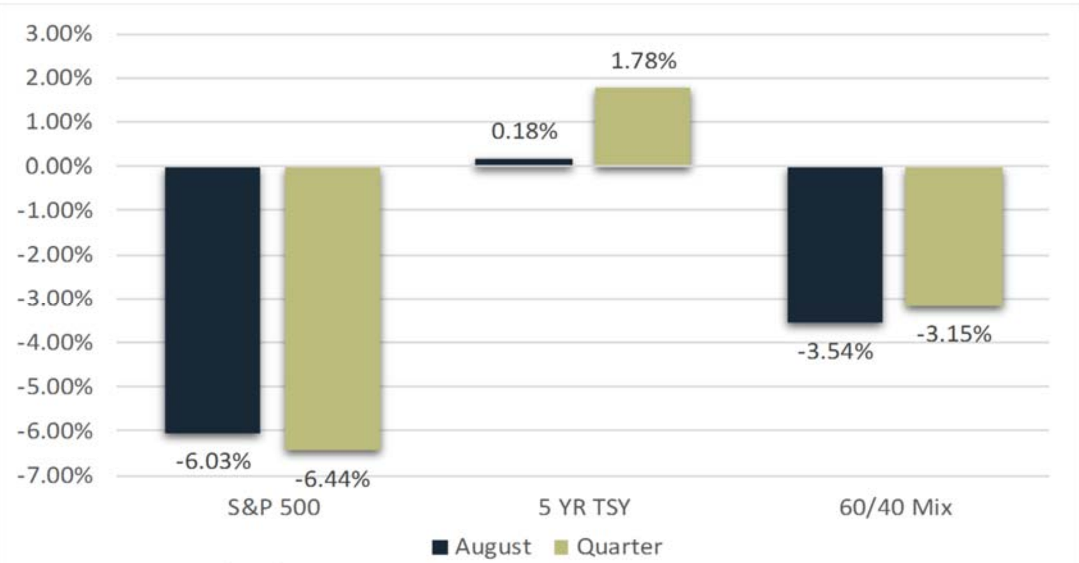
1) Security valuation

2) Asset allocation

3) Portfolio optimization

4) Performance measurement

The second step is the most important step in reducing overall volatility and smoothing out returns. Without being too self serving, we believe that fixed income should be a permanent allocation in an investment portfolio.




Source: Bloomberg

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