ASSET PRESERVATION ADVISORS

Trading Markets

Increase in Rates, Supply Continues to Remain Low

National Economic Update

The U.S. economy continued to show signs of improvement in June and early July with a pickup in strong economic numbers, including a surprisingly upside jobs report that resulted in a decrease in the unemployment rate. The Labor Department stated that employers added 288,000 net jobs in June, with overall growth in jobs over the past 3 months averaging 272,000 per month. As a result, the national unemployment rate for the month of June fell to 6.1%, reaching its lowest level since September of 2008. Despite this positive economic data, much of the instant bond selloff was kept at bay by what the Fed still sees as "considerable slack" in the labor market and by the fact that the personal consumption expenditures (PCE) inflation rate is still running lower than the Fed's 2.0% target rate. Many pundits disagree with the Fed and see inflation picking up quicker than Yellen and her team are acknowledging. This conflict, coupled with the recent pickup in supply weighed heavily on the municipal market, with returns falling flat or negative for the first time this year in June.

Manufacturing, which accounts for approximately 12% of total economic output, grew at a slightly slower pace in June. The Institute for Supply Management (ISM) reported that its overall index decreased slightly to 56% in June from 56.3% in May. Expansion was reported in 14 industries, with the best-performing sectors being construction, real estate and management of support service.

After an increase in the May Consumer Confidence score of 82.2%, the Conference Board reports the Index stood at 85.2% in June, continuing it's upward trend. The Consumer Confidence Survey is a leading indicator that tracks the national economy as consumer spending accounts for 70% of U.S. GDP. The "Present Situation Index", which measures consumers' feelings about their current economic situation, also increased to 85.1% in June from 80.3% in May.

Rates and the Yield Curve

Municipal rates moved higher in June, underperforming the treasury market, which experienced a slight rally over the month. The AAA MMD 10 year yield rose from 2.16% to 2.26%, while the 30 year AAA MMD yield increased from 3.26% to 3.28%. Comparable treasury yields fell slightly from 2.54% to 2.53%, and from 3.38% to 3.34%, respectively. The yield curve continued to flatten, with the 10-30 year spread falling to 104, down from the 142 basis point spread we saw at the start of the year. Depending on ongoing discussions of when the Fed will decide to raise short term rates and if and when we begin to see a sizable uptick in inflation, we may continue to see a flattening of the yield curve over the second half of the year.

Muni Supply and Demand

June saw the largest supply of the year with $34 billion in new issuance. However, municipal supply year to date is running 15% lower, at $149 billion in total issuance, compared to the same period last year. Much of this added supply was easily absorbed by continued inflows to mutual funds and strong coupon payments during the months of May, June and July. Muni funds saw a net inflow of over $1 billion, marking the sixth consecutive month of net inflows. While the June numbers were a positive sign, the added demand was virtually half of the inflows seen last month. As investors look for more return and jump on the last remaining "steroid boost" given to the equity market, we feel that muni funds could continue to see reduced demand which may put additional pressure on the municipal market.

Limited supply and investor demand for yield were the key issues in the second quarter of 2014. The unemployment rate fell to a new low and the yield curve flattened. Investors should ask themselves "Is it déjà vu all over again" when comparing 2014 to other years.

In This Issue

Muni Credits to Watch

DETROIT

- The Detroit bankruptcy continues to make headlines. On July 14, Detroit's public workers, retirees and bondholders voted on a plan that would reduce payments to investors and pensioners. Investors, along with current and former employees, may have to take $10.4 million less than they are owed. The final plan would have to be approved by U.S. Bankruptcy Judge Steven Rhodes, with the certified voting results not being be available until late July. This follows a federal mediator in June announcing that the city had reached a deal with bondholders on their limited-tax debt to offer 34 cents on the dollar. In April, Detroit agreed to pay unlimited tax general obligation bondholders 74 cents on the dollar.

PENNSYLVANIA

- The State of Pennsylvania's rating may be downgraded in the next few months as that state struggles with financial challenges and pension issues. That state's lawmakers went on summer recess without addressing increasing pension costs that are forecasted to increase 38% in 2018. In 2013, the combined funded ratio dropped to 62 % from 75 % in 2010. The state also faces financial challenges resulting from the recession and underperforming state economy. Pennsylvania is currently rated AA by Standard and Poors (S&P), Aa2 by Moody's and AA from Fitch. S&P stated they will re-evaluate the rating in the coming months as did Fitch. At the time of this printing, Moody's stated they will not modify the rating or outlook.

Credit Markets

Puerto Rico: "General Hospital" or "Guiding Light"?

Like watching a soap opera, investors in Puerto Rico debt have not experienced a dull moment since Barron's and other leading news services warned of an imminent demise and the "troubling winds" facing the Commonwealth, almost a full year ago. Many investors were enticed by the triple tax exemption status and ignored the underlying economic and financial issues facing the Commonwealth. More recently as the Puerto Rico market has weakened dramatically, outflows from municipal mutual funds have intensified as investors shy away from mutual funds with large exposures to Puerto Rico debt.

As paper backed by the Island's full faith, sales tax and agencies suffered, buyers were forced to choose between liquidating or holding onto their current positions with a government whose ability to borrow was coming under scrutiny. Last March, the sinking GDB was able to get a blockbuster deal successfully placed. Even though much of the 8.727% $3.5 billion deal went to non-traditional municipal buyers, the deal was deemed a huge success and was set to fund the U.S. Territory's operations for the next 2 years. Trading on this deal was strong to start, with the original issue price of 93.00 rallying as high as 99.00 in the days following.

Even with the small confidence boost this deal gave investors, the majority of the Commonwealth's debt continued to trade at distressed levels, with very little regard to the rating. This continued up until June 25, when in an effort to boost the credit characteristics of general obligation and COFINA (sales tax) debt, the Governor of Puerto Rico, Alejandro Garcia Padilla, proposed legislation that would let certain public corporations restructure debt. He wanted to separate agencies such as the Puerto Rico Electric Power Authority, or PREPA, and the Puerto Rico Aqueduct and Sewer Authority, or PRASA, away from the GO and sales tax backed bonds, so the support given to these entities over the years will not weigh further on what they consider to be strong credits. This action sent the prices of PREPA, PRASA and public authorities (including the highway and ports authority) down to record lows between 35 and 40 cents on the dollar; it also dealt a large blow to investor confidence on the overall credit of Puerto Rico and their willingness and ability to pay. Padilla and the rest of the GDB claimed that this would be a positive move going forward, and were even able to pass the first balanced budget in more than a decade. The market and rating agencies disagreed, however, as evidenced by the chart on the following page, with all three services slashing ratings across the board, even on COFINA debt, which many viewed as the strongest credit on the Island.

PREPA has the largest outstanding debt balance at nearly $8.6 billion and has been receiving the most attention; however, a successful interest payment on July 1 has not stopped the largest holders of the debt from bringing suit against the restructuring law. Under the U.S. Constitution, only a federal bankruptcy court has the power to force creditors to accept changes to a debt contract, such as reduced payments. The investor lawsuit was soon followed by a release by Padilla and his team claiming that the ratings actions "is unfair to the people of Puerto Rico and disregards the hard work undertaken to date to get the finances of the Commonwealth in order". He threatened to sue Moody's, saying that they will have to answer for this offense. Again, Padilla reiterated that the restructuring bill "protects the general fund, the GDB and the Commonwealth's credit, and in no way indicates any shift in the Commonwealth's historical and constitutionally supported commitment honoring its financial obligations". With all of the back and forth, many traditional municipal buyers have left the Puerto Rico market, but the slack has been quickly picked up by hedge funds and other distressed taxable buyers; not many other alternative instruments provide the kind of yield found on these, now junk, credits.

Puerto Rico will be an ongoing story to watch, but has already had implications affecting the overall municipal market. Not only have we seen outflows from some of the aforementioned mutual funds still invested in Puerto Rico, but we have also seen spreads widen on many of the lower rated credits that have fallen to the background as most long yield trading focuses entirely on Puerto Rico.

Credit Markets Cont'd

Puerto Rico Credit Ratings

Entity	Description	Moody's Rating	Moody's Outlook	S&P Rating	S&P Outlook	Fitch Rating	Fitch Outlook
GO	General Obligation	B2	Outlook Negative	BB	Outlook Negative	BB-	Outlook Negative
GDB	Government Development Bank	B3	Outlook Negative	BB-	Outlook Negative	NR	N/A
COFINA	Sales Tax Corporation (Senior Lien)	Ba3	Outlook Negative	BBB	Outlook Negative	BB-	Outlook Negative
COFINA	Sales Tax Corporation (Subordinate Lien)	B1	Outlook Negative	BBB-	Outlook Negative	BB-	Outlook Negative
PREPA	Electric & Power Authority	Caa2	Ratings Under Review	B-	Watch Negative	CC	Watch Negative
PRASA	Aqueduct & Sewer Authority (Guaranteed)	B2	Outlook Negative	BB+	Watch Negative	BB-	Outlook Negative
PRASA	Aqueduct & Sewer Authority (No Guarantee)	Caa1	Ratings Under Review	BB+	Watch Negative	B+	Watch Negative

Illinois Retiree Healthcare Premiums Protected

The State of Illinois, with one of the lowest credit ratings in the nation, lost a court case they had hoped would reduce their pension and healthcare costs. On July 3, 2014, the Illinois State Supreme Court ruled that the state of Illinois cannot reduce contributions to retirees' health-insurance premiums. In a 6-1 decision, the Court ruled that the health-insurance premium subsidies are considered pension benefits and are therefore protected by the state's constitution. The Court reversed a lower court decision to dismiss the case and sent it back to the lower court for review. In 2012, the Illinois legislature ended automatic premium subsidies for members of the three of the state's five pension funds that were based on length of service. Prior to 2012, the subsidy level was automatic but was now determined by the State's Department of Central Management Services. Three of the state's unions filed suit, with the Court ruling in favor of the unions by stating "The State's provision of health insurance premium subsidies for retirees is a benefit of membership in a pension or retirement system and the General Assembly was precluded from diminishing or impairing that benefit for those employees, annuitants, and survivors." If the court ruled in the state's favor, the state was expected to save some $900 million over the next three years.

Additionally, a case involving the state's pension overhaul was filed in December 2013, with the state making a slightly different argument. In this retiree healthcare case, the state argued those benefits do not enjoy constitutional protection. With the pension reform case, the state is arguing that the financial challenges the state is facing could threaten the solvency of the funds and that the state offered pension members "consideration" for the benefit reductions by restoring solvency to the funds. The aforementioned retiree healthcare case could offer market participants and other interested parties some insight into how the Court may rule in the pension case, thus siding with pensioners. In addition, these two cases could provide other states with a legal framework to use when deciding on pension and health care benefits funding reforms.

This ruling had a minor effect for Illinois paper, according to data compiled by Bloomberg that showed investor demand to own Illinois GO's, when compared to the AAA benchmark, increased to 128 basis points and as of July 14 was at 132 basis points. However, this is the highest spread since February 2014.

Benchmark States 10-Year Yields		
State	**Yield (%)**	**Spread to AAA (bps)**
California	2.77	+31
Florida	2.59	+14
Illinois	3.77	+132
New York	2.55	+11
Pennsylvania	2.79	+34
Texas	2.59	+14
Wisconsin	2.75	+30

Graph Sources: Moody's, S&P, Fitch, Bloomberg, Goldman Sachs Securities. As of July 13 & 14, 2014

Final Thoughts

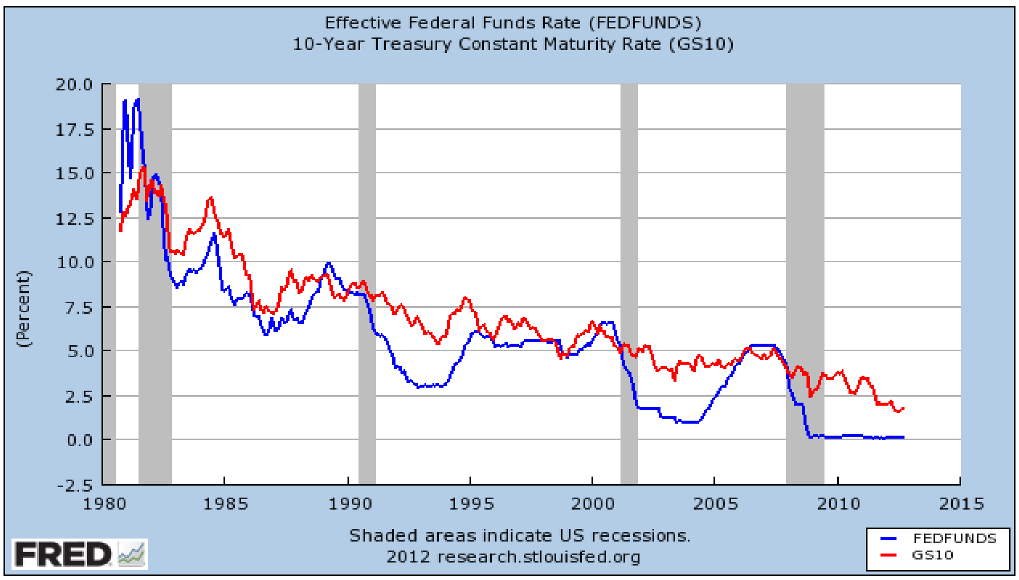
Could the 2014 bond markets experience déjà vu from 2004?

The bond market environment in 2004 will go into the history books as one of the strangest periods in bond market history. Allan Greenspan, then chairman of the Federal Reserve, was so perplexed by the phenomenon while delivering his semiannual Monetary Policy Report to Congress that he could only describe it as a “conundrum”. It was incomprehensible for longer term treasury yields not to rise in accordance with the federal funds rate.

What was so unusual about 2004?

During the latter part of 2004, long term interest rates began to trend lower, even though the Federal Reserve had raised the level of the target federal funds rate by 150 basis points. This scenerio suggests that something was different this time during this period of Fed tightening. Usually an increase in short term interest rates are accompanied by a rise in longer term yields.

Look at the chart below and you will see that the 10-year treasury yield almost always moved in tandem with the federal funds rate up until 2004.



Part of the answer to the "conundrum" was that foreign buyers of treasuries had increased their holdings from 20% in 1994 to 57% in 2007. Over the last four years, the Federal Reserve has been a large buyer of treasuries in their QE operation. There are estimates they own over 30% of all outstanding government debt. Their balance sheet has ballooned from just under one trillion in 2008 to over four trillion as of today. Recently, the U.S. released treasury holding data that showed China is currently very active in the U.S. market again; “The Chinese government has increased its buying of U.S. Treasuries this year at the fastest pace since records began more than three decades ago. The world’s most-populous nation increased its official holdings of Treasury debt maturing in more than a year by $107.21 billion in the first five months of 2014, according to the U.S. government data. China officially holds roughly $1.27 trillion of U.S. debt, about 10.6% of the $12 trillion U.S. Treasury market”.

What is the most effective investment approach for our intermediate bond portfolios given the possibility of a repeat of the 2004 market?

APA feels that the most effective approach to protect our portfolios when the Federal Reserve begins to raise short interest rates is to use a modified barbell strategy: 50% of the portfolio would be invested in the 0 to 3 year maturity range, while the other 50% would be invested out in the 10 to 15 maturities. The portfolio would have little exposure to the 4 to 9 year part of the curve, which we feel would see the most underperformance if we repeat the 2004 "conundrum".

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