ASSET PRESERVATION ADVISORS

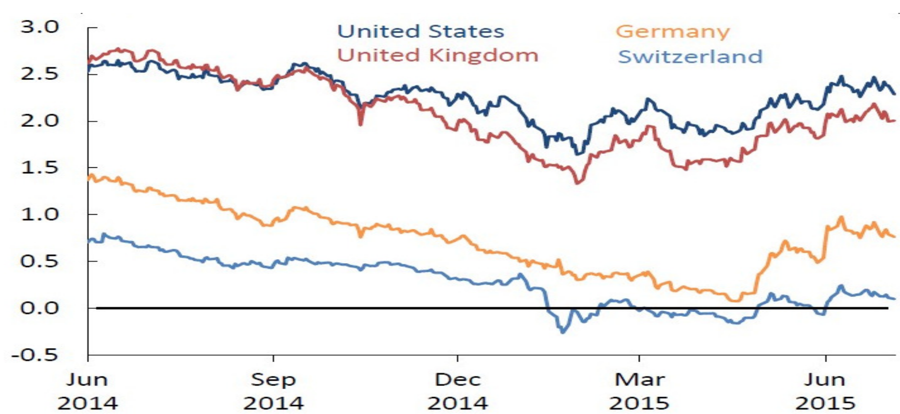
2Q 2015: Global Economic Uncertainty & Fear of Rising Interest Rates Fuel Market Volatility

Improving U.S. Economic Conditions Point to an Imminent Fed Rate Hike

Volatility continued to play a dominant theme in financial markets during the second quarter of 2015, as anticipation of a Fed rate hike later in the year and highly-publicized events out of Greece, China and Puerto Rico rattled investor confidence. After experiencing a mild first-quarter contraction of –0.2%, partly reflecting transitory factors such as severe winter weather, the west coast port shutdown, and the negative impacts of a stronger dollar and falling oil prices on U.S. exports and energy production, U.S. economic conditions appear to have rebounded in the second quarter. Domestic GDP growth is expected to be positive for the second quarter, driven by notable improvements in the housing sector, labor market, auto sales and consumer spending. More importantly, there have recently been some hints of a pick up in wage growth and inflation. U.S. Federal Reserve (Fed) Chair Janet Yellen continues to express that U.S. monetary policy normalization remains data-dependent and will involve a slow and incremental increase in rates with the initial liftoff occurring later this year. Growing global economic concerns, fueled by the recent economic slowdown and bear market in China, could have the potential to delay any action taken by the Fed. Given the contained inflationary environment and ongoing fragility of the U.S. and global economy, APA predicts a slow and gradual rise in rates with the initial Fed liftoff occurring either late in 2015 or next year. We forecast a prolonged period of heightened global market volatility in the near term due to ongoing uncertainty surrounding Fed policy expectations and the unresolved debt crises in Puerto Rico and Greece. Moreover, monetary policy divergence between global central banks will continue to keep downward pressure on U.S. government bond yields. While the Fed moves toward interest rate policy normalization, 37 central banks around the world have eased monetary policy so far this year in an effort to stimulate growth and/or fight deflationary pressures. China's National Bureau of Statistics recently reported that GDP growth remained at 7% in the second quarter, matching China's first quarter growth rate. The 7% growth rate in 2Q15 marked the slowest quarterly growth since the depths of the recession in 1Q09 when the economy expanded by only 6.6%.

Increased supply, higher yields, and a handful of distressed headline credits led to increased market volatility and detracted from municipal performance during the second quarter of 2015.

10 Year Government Bond Yields



Sources: Bloomberg L.P.

A sharp correction in Eurozone bonds sparked a rise in U.S. interest rates and contributed to lackluster quarterly performance. After reaching record low negative yields following the launch of the European Central Bank's QE program earlier in the year, Eurozone government bonds experienced an abrupt selloff that triggered a broader increase in global interest rates. The selloff, which was partly prompted by an uptick in inflation and stronger-than- expected growth in the Eurozone, spurred 10-year German bund yields to rise 90 basis points (bps) from a low of .075% at the end of April to 0.981% in early June. U.S. markets were not spared from the spillover in volatility, with the 10-year Treasury yield rising 63 basis points from a low of 1.87% to 2.50% over the same time period. A late quarter flight-to-quality rally helped drive down yields and boost prices on U.S. bonds, triggered mainly by growing concerns over a Greek default or exit from the Eurozone. The last minute rally unfortunately was not enough to boost market performance, as 2Q15 marked the biggest quarterly selloff in U.S. government bonds since December 2013. APA believes the U.S. Treasury market in 2015 will remain heavily influenced by the Eurozone bond market and investor concerns or optimism on economic outcomes overseas. APA believes contagion risk from the Greek debt crisis will be minimal, as this is the third bailout for the distressed country , which only accounts for a mere 2% of Eurozone GDP, and European private banks have significantly reduced their exposure to Greek debt since the country first came under market pressure in 2010. APA believes demand for U.S. government debt will remain strong as domestic yields are attractive relative to other sovereign debt.

In This Issue

Affordable Care Act Supreme Court Update

Good news for hospitals and the previously uninsured. On June 25, the Supreme Court opined on the King v. Burwell case involving insurance premium subsidies, which are a key component in the Affordable Care Act (ACA) of 2010. By a 6-3 vote, the Court ruled to uphold the federal health insurance exchange (HIE) premium tax subsidies. The six justices that upheld the healthcare law stated the law allows residents in all states and not just those states that established their own exchanges to receive the subsidies. There are an estimated 6.4 million Americans who receive the subsidies in the 34 states that did not establish their own exchanges.

Without the subsidies, those individuals would not be able to afford health insurance. Opponents of the subsidies believed they should only be available to those who enroll through an "exchange established by the state." The federal government argued that the law's purpose was to allow all residents in every state to be eligible for the subsidies. Had the court ruled against the subsidies, the number of uninsured would have increased and hospitals might have seen an increase in bad debt due to the uninsured not being able to pay for their services. This ruling should ultimately aid hospitals bottom line by reducing bad debt expenses. Republicans were hoping to repeal and replace ACA, but the court ruling left little chance that any legal challenges will occur before 2017. Any action by Congress will surely be vetoed while President Obama is in office. So for now, ACA is the law of the land.

Increased Supply and Negative Headlines Hamper Municipal Bond Performance

The municipal market faced multiple headwinds during the past three months that resulted in slightly negative returns for the quarter. On top of the economic and global concerns mentioned above, the municipal market was also pressured by heavy issuance and a barrage of negative credit headlines. After 16 consecutive months of inflows, municipal mutual funds experienced outflows of -$642 million in May that accelerated to -$1.039 billion in June thru 6/24/15, according to ICI data. As investor demand waned, the market experienced high new issuance volume with $220.2 billion in supply year-to-date, representing a year-over-year increase of 42%. Year-to-date issuance has primarily been driven by refunding activity, which has accounted for 66% of 2015 supply, as issuers capitalize on lower rates to refinance higher cost outstanding debt. Refunding activity appears to be slowing, and therefore APA does not forecast a significant increase in overall net supply to pressure the market over the latter half of the year. The mutual fund outflows coincided with negative media coverage on a handful of distressed credits including Puerto Rico, Illinois, Chicago, and New Jersey, which we will discuss in further detail in the next section.

The municipal yield curve steepened over the second quarter as a result of these headwinds and higher Treasury yields, causing longer maturities to underperform the short end of the quarter for the majority of 2Q15. Lower-rated bonds also performed poorly during the quarter due to a sharp sell-off in lower-rated credits, most notably bonds issued in Puerto Rico. Municipal bonds were able to slightly outperform Treasuries which experienced higher volatility over the quarter.

Date	1-yr	3-yr	5-yr	7-yr	10-yr	12-yr	15-yr	20-yr	30-yr
3/31/15	0.19	0.82	1.24	1.60	1.96	2.18	2.45	2.67	2.80
6/30/15	0.31	0.93	1.38	1.89	2.28	2.53	2.77	3.01	3.28
Change in bps	+12	+11	+14	+29	+32	+35	+32	+34	+48

Source: Thomson Reuters MMD

APA Credit Spotlight

Puerto Rico Restructuring Does Not Pose a Systemic Risk to the Municipal Market

Negative media coverage of Puerto Rico's debt crisis added to municipal market volatility over the quarter; especially following Governor Alejandro Garcia Padilla's announcement in June that the island would not be able to make upcoming debt payments in full. The Governor's warning triggered a sharp decline in Puerto Rico bond prices but has yet to significantly impact the broader municipal market, as news of the island's fiscal distress did not come as a surprise to many long-term investors. Unlike the majority of U.S. state and local governments that have experienced drastic improvements in credit fundamentals since the 2008 financial crisis, Puerto Rico continues to suffer from nearly a decade of deficit financing as a result of the ongoing economic contraction, population loss, high unemployment and poverty levels, and increasing debt liabilities. To help put the Commonwealth's debt levels in perspective, the island's net direct debt per capita of $15,637 is more than 10x the average for the 50 states and equals 87.5% of personal income compared to the U.S. state average of 3.1%, according to Moody's. Furthermore, the Commonwealth's pension system is severely underfunded with a reported funded ratio of only 6%. Puerto Rico's substantial fiscal challenges over the past few years have been well-publicized, just as Detroit's financial troubles and subsequent default were, and therefore have most likely been priced into the market since as early as 2013. APA believes the impending Puerto Rico debt restructuring will not have a substantial impact on the overall municipal market, as most informed investors are able to recognize the unique debt and economic crises facing the island. Moreover, it is important to keep in mind that the $72 billion in debt outstanding issued by the Commonwealth and other public corporations such as PREPA, the electric and power authority, only represents a mere 2% of the nearly $3.7 trillion municipal bond market. Despite accounting for a small portion of the overall muni market, Puerto Rico debt is widely held due to it's triple tax-exempt status, with currently 20% of all U.S. Bond Funds invested in Puerto Rico bonds. Therefore market participants currently invested in mutual funds could be negatively impacted by forced selling pressure, should outflows persist. According to March 31, 2015 data released by Morningstar, Oppenheimer Funds Inc. and Franklin Advisers Inc. together owned approximately $10.8 billion in Puerto Rico bonds, representing 15% of the Commonwealth's outstanding debt. APA will continue to monitor ongoing developments in the island's debt restructuring negotiations and the potential implications for the broader market; however, we do not believe Puerto Rico bonds are suitable for inclusion in high quality municipal portfolios and maintain our negative outlook and sell recommendation.

State Spreads Widen Over the Quarter Due to Uneven Economic Recovery and Pension Issues

APA believes overall credit fundamentals in the municipal market are strong and trending upward, with state and local governments continuing to benefit from improving economic conditions and increasing revenue collections. The economic recovery has been not been even across the nation, however, as indicated in the graph below which shows individual state GDP growth for fiscal year 2014. Moreover, the rebound in state revenues has varied widely due to the different allocation and mix of tax revenues each state relies on. For example, Alaska's fiscal position has suffered greatly from the recent collapse in oil prices, with oil and gas severance taxes accounting for roughly 90% of the state's General Fund revenues. Alaska is now facing an unprecedented general fund deficit of $3.5 billion, but the credit weakness is offset by the state's strong reserves with a $14 billion savings fund. Meanwhile, California income tax collections, which serve as the state's primary source of revenue, beat estimates by more than $1.6 billion in April, contributing to an $8 billion growth in revenue for the first four months of 2015 compared to the same period last year. California has received multiple credit rating upgrades over the past few years as a result of the successful structural balance measures enacted under Governor Brown's administration that include paying down the state's outstanding debt and building up rainy day funds. A recent study by the Mercatus Center ranked each state by fiscal condition based on FY 2013 audited financials (See chart below). The top five states—Alaska, North Dakota, South Dakota, Nebraska, and Florida—benefit from strong reserves and significant amounts of cash on hand with relatively low short-term debt burdens. The bottom five states were Illinois, New Jersey, Massachusetts, Connecticut, and New York. These states remain challenged by structural imbalances, low liquidity and reserves, and large short and long-term debt obligations.

Ranking of States by Fiscal Condition (FY 2013)

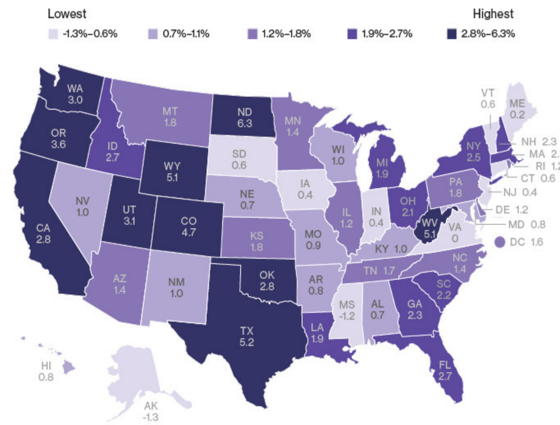
Rank	State	Fiscal condition index	Rank	State	Fiscal condition index
1	Alaska	8.26	26	Georgia	−0.58
2	North Dakota	2.97	27	North Carolina	−0.63
3	South Dakota	2.84	28	Wisconsin	−0.64
4	Nebraska	2.75	29	Arkansas	−0.66
5	Florida	2.74	30	Delaware	−0.69
6	Wyoming	2.67	31	Minnesota	−0.70
7	Ohio	1.30	32	Arizona	−0.78
8	Tennessee	1.10	33	Mississippi[a]	−0.78
9	Oklahoma	0.99	34	Michigan	−0.80
10	Montana	0.98	35	Louisiana	−0.85
11	Utah	0.95	36	New Mexico[b]	−0.92
12	Nevada	0.62	37	Maryland	−0.98
13	Alabama	0.60	38	Rhode Island	−1.06
14	Missouri	0.49	39	Vermont	−1.08
15	Idaho	0.32	40	Hawaii[c]	−1.08
16	Indiana	0.07	41	Pennsylvania	−1.14
17	South Carolina	−0.03	42	Maine	−1.15
18	Iowa	−0.04	43	West Virginia	−1.20
19	Texas	−0.12	44	California	−1.41
20	New Hampshire	−0.13	45	Kentucky	−1.42
21	Virginia	−0.21	46	New York	−1.49
22	Colorado	−0.27	47	Connecticut	−1.83
23	Washington	−0.43	48	Massachusetts	−1.84
24	Kansas	−0.48	49	New Jersey	−1.86
25	Oregon	−0.50	50	Illinois[d]	−1.86

Source: Eileen Norcross, "Ranking the States by Fiscal Condition" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2015), 28; using data from analysis of the most recent Comprehensive Annual Financial Reports (CAFRs) for all 50 states.

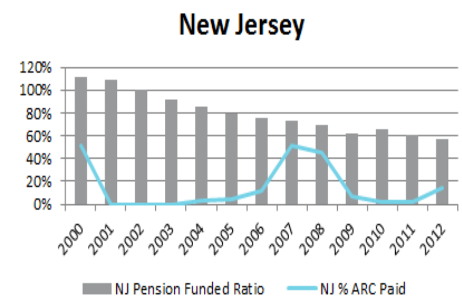
Note: The fiscal condition index is the sum of the cash, budget, long-run, service-level, and trust fund solvency indexes weighted as follows: (0.35 × cash solvency score) + (0.35 × budget solvency score) + (0.1 × long-run solvency score) + (0.1 × service-level solvency score) + (0.1 × trust fund solvency score).

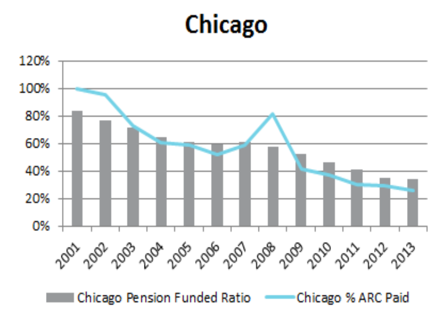
GDP Growth by State

Percent change in real GDP, 2013–2014



Source: Bureau of Economic Analysis





APA believes the health of state and local pension systems is one of the most distinguishing credit factors in the current municipal market. We believe it is essential to include pensions in the evaluation of state and local governments, as pension contributions are paid from the same source of tax revenues as debt service and therefore pose a risk to bondholders. A number of factors can be attributed to the wide disparity between the strongest and weakest funded plans, including the different assumptions determined by pension board members that drive liability calculations and funding practices. In general, pension systems are extremely sensitive to stock market volatility with investment earnings accounting for an average 45% of total funding. As a result, a large majority of pension funded ratios significantly declined during the recent recession due to revenue underperformance. Challenged by ongoing sluggish economic and revenue growth, a number of governments have reduced or eliminated pension contributions in order to balance their budgets in recent years. Each year the actuarial required contribution (ARC—the annual amount necessary for a pension system to be fully funded) is underfunded, both the ARC and the long-term pension liability increase, thereby further reducing the funded ratio. As indicated by the graphs above, the state of New Jersey and the city of Chicago exemplify the detrimental impact of chronic underfunding and associated compounding growth of pension liabilities.

APA believes rating agencies and market participants will continue to place more emphasis on long-term pension obligations when evaluating municipalities going forward. We have already witnessed multiple downgrades and widening credit spreads on state and local governments with large unfunded pension liabilities and limited long-term solutions including Illinois, New Jersey, Chicago, Pennsylvania, Connecticut and Houston. Pension reform may pose a significant challenge for many governments due to constitutional or statutory restrictions, as evidenced by a number of recent pension reform measures being overturned and ruled unconstitutional as was the case in Illinois, Chicago, Arizona and Oregon. Despite the troubled credits detailed above, state pension funding levels have generally recovered after hitting all time lows during the Great Recession. According to a recent report issued by the Pew Center, weighted average pension funding ratios increased to 73.1% in 2014 from 72.7% in 2013 as market gains helped offset growing liabilities. Twenty states now have pension systems that are 75% funded or greater, while Illinois and Kentucky still have pensions that are less than 50% funded.

A Look Ahead: Muni Market Outlook for the Second Half of 2015

APA believes municipals are still attractively priced and offer investors relative value and historically less volatility in a rising rate environment compared to their taxable counterparts. The second quarter increase in yields may help garner investor demand, which could support the market during the second half of the year. Municipal market momentum and bond valuations are highly influenced by retail investor sentiment, as evidenced by the widening spreads of highly-publicized distressed states and municipalities over the course of 2Q15. APA believes that periods of sharp volatility and market dislocation have the potential to create attractive buying opportunity for investors with the ability to conduct extensive credit analysis and take advantage of pricing inefficiencies.

APA's investment strategy for the latter half of 2015 includes remaining duration neutral to the appropriate benchmarks and maintaining a high level of credit quality in our clients' portfolios, while seeking to obtain incremental yield through in-depth, internal credit analysis. Our credit research group is dedicated to looking beyond media headlines and rating agencies in order to evaluate the underlying credit fundamentals of bonds in an effort to identify under or overvalued bonds in the market. We also continue to employ a barbell investment approach, emphasizing both the 0-2 year and 9-14 year maturity ranges. APA feels the barbell structure serves to take advantage of the steep yield curve while limiting the average duration and positioning our clients' portfolios to take advantage of future higher rates. We currently underweight the 3 to 7 year range as we find this part of the curve to be highly susceptible to yield increases and is sensitive to ongoing volatility in the Treasury market.

In addition to attractive relative value, the average credit quality of municipal bonds remains notably higher than other fixed income investments and therefore we believe does not expose investors to a significant default risk. In a recent report released by S&P and based data in the period from 1986-2014, the 10-year cumulative default rate for investment grade municipal bonds was 0.14% and 0.24% for the entire municipal bond market. This compares to default rates of 2.81% and 11.16% for the corporate investment grade bond market and the entire corporate bond market, respectively.

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Final Thoughts

by Ken Woods

States and Municipalities—A Backdoor Way of Printing Money

"Credit selection has never been more important than it is today."—Paul Nolan, APA Head of Municipal Research

The old saying in the muni market is that states and municipalities have to balance their budget each year because they can't print money like the U.S. government. Well, in retrospect, over the last 15 years or so, some of these state and local governments have been spending money that they really didn't have.

Until recently, the pension and health benefits they promised to state and local employees were off balance sheet items. That's right; they were unaccounted for over many years and egregiously and recklessly underfunded. The unfunded amounts are in the billions and still building. In reality, they were creating money by pushing these liabilities off for future elected officials to deal with and they were using that money for current expenses. Political leaders were hoping that when these liabilities came due, that they would be able to meet these obligations hopefully with flush future revenues, or like the current popular saying goes, they were "kicking the can down the road".

I am perplexed why the accounting industry knowingly countenanced this practice. In 2014, the Government Accounting Standards Board (GASB) have made positive changes to the standard accounting methods; now municipalities have to bring these liabilities back on their balance sheets and start to accrue for these future pension and health liabilities. Needless to say, some of the greatest offenders are having a difficult time trying to account for unfunded liabilities in their budgets. Illinois, Connecticut and Kentucky are about 40% funded and cannot seem to find solutions. APA has pointedly avoided these states and municipalities. We feel that more pain is ahead before they can find solutions to these issues. This is not to say that all states and municipalities were offenders. States like Wisconsin 99.9 %, South Dakota 99.9%, Oregon 97.1%, New York 88%, Florida 85% and many others are above 75% funded mark. Our Credit Research Group (CRG) believes that many of these states that are less than 100% funded can make the necessary adjustment to their current and future budgets to bring back these numbers closer to acceptable levels.

The good news is, that over the last few years, their revenues have improved and if this trend continues, we should see better funding ratios. The municipal bond market is slowly becoming a more transparent place to invest thanks to the accounting changes and more timely reporting of vital information. These changes will help investors to differentiate from those credits that perform their duties correctly and those that do not.

For additional information on individual state pension funds, please visit https://projects.propublica.org/graphics/pension_bonds

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