Trading Markets

What is Fair Value in an Uncertain Global Economy?

As the global hunt for yield continues, concerns are mounting over whether markets worldwide are in the midst of a bubble. Some might say with good reason too, as U.S. stock markets set new record highs daily and U.S. Treasury yields inch lower. But what is fair value? What is fair value when the U.S. has seen little inflation pressure and inflation abroad is almost non-existent? What is fair value when growth forecasts among the world's largest economies are being revised down from already low estimates? What is fair value when Spain, which two years ago was fighting for solvency, is now fetching less than 2.10% for 10 year debt? What is fair value when Germany, Europe's strongest member, has disappointed on all recent economic data but has a 10 year that still trades at less than 1.00%? Yes, the United States jobs market is picking up, but at the expense of a reduced participation rate and an insignificant increase in wages. With the 10 year Treasury at 2.32%, or 22 basis points (bps) higher than Spain…what is fair value?

The Fed is trying to exit QE with a smooth transition, stating their intentions with more forward guidance than we have seen; but, with every positive economic data point comes a balancing negative number that leads FOMC members to intently edit all language as to not upset the market and send an otherwise volatility-free market into chaos. With the most recent FOMC minutes (Oct 8), we see participants expressing concern over the recent strength of the dollar and the "persistent shortfall of economic growth and inflation in the Euro area that could lead to a further appreciation of the dollar and have adverse effects on the U.S. external sector." Any further appreciation of the dollar could slow inflation progress towards the Fed's goal of 2%. Concerns about slower growth in China and Japan or "unanticipated events in the Middle East or Ukraine might pose a similar risk." So as we see the market pricing in the rise of short rates slated to begin during the middle of next year with a late 2015 median Fed Funds Rate estimate of a 1.375%, we have seen a severe flattening of the yield curve as longer, more market driven benchmark maturities are lower in yield. Since the middle of September, to the time of this writing, we have seen the S&P 500 decline 4%, while the 10 year U.S. Treasury yield has fallen 28 bps. As of October 8, the difference between 10 year yields and similar maturity TIPs (a gauge of expectations for consumer prices), was down to it's lowest since June 2013, at 1.91%. If we do continue to see the growth in the U.S. Economy that most participants are counting on, the built-in spare capacity should contain inflation to a gradual increase.

The municipal market continues to benefit from limited supply and strong investor demand, bolstered by a flight to quality in the midst of geopolitical tensions and global economic concerns. A flattening yield curve has longer maturity ranges outperforming the short end of the curve.

Favorable Supply/Demand Makes For A Firm Muni Market

All of these economic uncertainties, concerns and questions coupled with a year-to-date supply that is running 14% below last year's total is creating a very firm, high demand municipal market place. As the overall market shrinks in tandem with municipal mutual funds seeing YTD inflows of over $13 billion, real yields move lower and credit spreads continue to tighten, in some instances to historical levels. Longer and lower-rated credits are still at wider spreads than pre-2008 crisis levels, but as many of the same credits are recycled through the market, any different name is gaining the attention of bidders who are willing to pay up for any additional yield over AAA MMD Scale.

AAA MMD Scale (%)

	1 Year	3 Year	5 Year	10 Year	15 Year	20 Year	25 Year	30 Year
1/3/2014	.17	.59	1.32	2.79	3.50	3.89	4.11	4.20
10/8/2014	.13	.60	1.17	2.10	2.45	2.74	2.92	2.99

In This Issue

Muni Credits Downgrades

PENNSYLVANIA

• In September, the Commonwealth of Pennsylvania's rating was downgraded by Fitch to AA– due to their inability to address ongoing budgetary and pension issues. Fitch also stated Pennsylvania's unexpected revenue shortfall in fiscal 2014 and its budget for the current fiscal year, which includes a substantial amount of one-time revenue and expense items, led to the downgrade. Fitch warned that a failure to make fundamental structural changes to address its budget problems could trigger another negative credit action. Standard & Poor's Ratings Services also reduced the rating to AA- due to similar concerns. These actions follow Moody's downgrade of Pennsylvania's general obligation bonds one notch to Aa3 in July.

NEW JERSEY

• New Jersey saw its rating lowered by two rating agencies in September. Fitch downgraded the GO rating to A and assigned a negative outlook due to "… the absence of long-term, fiscally sustainable solutions to close identified budget gaps in fiscal years 2014 and 2015." A few days later S&P lowered the state's appropriation backed debt rating to A- reflecting their view that "New Jersey will face increased long-term pressures in managing its long-term liabilities, and the state's revenue and expenditure misalignment will grow based on reduced funding of the state's unfunded actuarial accrued liability". These rating actions brought the state's rating to the second lowest among the states, with only Illinois rated lower (A3/Neg; A-/Neg; A-/Neg/Moody's/S&P/

One of the biggest effects of this year's lack of supply, as APA noted at the start of this year, is the flattening of the yield curve that has occurred. We have seen an overcrowding on the short end of the yield curve where some AAA names trade as high as 60-65% of comparable U.S. Treasuries, as investors hide from any duration risk, but the best performing portion of the curve has been 10 years and out.

There have been whispers of supply picking up heading into year end. This has not proven to be true quite yet, and the heavier supply we have seen over the last couple weeks has been easily absorbed with most deals trading even higher in the secondary market. We do, however, expect to see more issuers take advantage of lower rates by issuing refunding debt. This will result in a larger calendar of new issue deals for the market to study, and should provide a steady pricing guide; however, none of these types of issues will increase the net supply of bonds outstanding. Outside of a few issuers, we believe the lack of large infrastructure projects should keep demand outpacing supply.

AAA MMD Term Spread (bps)

	1-30 Yr	1-10 Yr	5-15 Yr	5-20 Yr	5-30 Yr	10-20 Yr
1/2/2014	403	262	218	257	288	110
10/8/2014	286	197	128	157	182	64

Basel III Impact on The Municipal Market

On September 3, the U.S. Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation issued their final rule implementing the Basel III Liquidity Coverage Ratio (LCR) for large U.S. banks. The rule requires banks with more than $250 billion in assets to hold enough high quality liquid assets (HQLA) that can be quickly converted into cash to cover 100% of a projected 30-day cash outflow in a stressed scenario. Banks holding over $50 billion will have lighter liquidity requirements. The final rule comes after a year-long debate over what constitutes a HQLA, with municipal bonds being the most contentious issue amongst policymakers. In the end, municipal bonds were excluded from HQLA based on perceptions of liquidity, not credit quality, but the Fed has stated that it plans to consider a proposal designating certain highly liquid municipals as HQLA at a later date.

With the exclusion in place for now, we must look at the potential impacts the new liquidity rule could have on the municipal market. An assessment by Wells Fargo recently noted that, "although bank ownership of municipals has nearly doubled over the past five years to approximately 12 percent of total holdings, it is still well below the 44 percent held by U.S. households. Further limiting potential bank influence, regulators have indicated that of the $425 billion in municipal securities held by U.S. banks, approximately half are held by the large institutions subject to the new rules". APA believes that reduced demand by banks poses only incremental pressure on municipal prices and we do not see it as a primary driver in the current market environment. We feel that despite the elimination of regulatory incentives, municipal bonds continue to be an attractive option for banks in the current low rate environment, as they offer attractive tax-free yields and credit diversification. Moreover, in the short term, the municipal market continues to benefit from a favorable supply/demand imbalance that will help offset any reduction in bank demand. Longer-term implications of the new liquidity rule are more difficult to assess but may include higher borrowing costs for municipal issuers, especially smaller issuers that currently hold the "bank-qualified" designation. With the Fed considering the possibility of including certain municipals bonds as HQLA in the future, APA believes investors may benefit from an overweight position in high quality, highly liquid bonds that could qualify as HQLA at a later date. We will continue to monitor market developments relating to the new liquidity rule as we evaluate credits and actively manage portfolios.

Credit Markets

Stockton Court Ruling

In what APA considers a win for investors with potential repercussions throughout the municipal market, U.S. Bankruptcy Judge Christopher Klein did not grant California Public Employees' Retirement System (CalPERS) special protection in a recent hearing for Stockton's bankruptcy case. The ruling allows bankrupt cities such as Stockton to cancel contracts with CalPERS, as federal law supersedes state bankruptcy laws. Later this month, the judge will decide how to apply the ruling to the city's reorganization plan, which is designed to protect CalPERS.

Municipal market participants, analysts, bankruptcy lawyers and public-pension advocates have been closely watching the Stockton bankruptcy case to see whether the court would rule in favor of CalPERS and pensioners, or if the judge would side with investors, in this case California-based money manager Franklin Resources, Inc. Franklin has criticized the bankruptcy plan as unfair. The company claims CalPERS should not be given special treatment and pensioners should also take a reduction in payments, just as investors have had to take less than they are owed for bond holdings. Stockton's debt reorganization plan is designed to protect CalPERS from any reductions while imposing reductions on Franklin and other investors. Under the proposal, CalPERS would be fully repaid while two of Franklin's funds would get back only about 1 percent of the unsecured portion of the $36 million owed. CalPERS argued California cities should be legally bound to use all their assets to pay pension debt before reducing retirement benefits.

Judge Klein did not agree and stated state's public employee retirement law "is simply invalid in the face of the U.S. Constitution." Similar to other agreements modified in federal court under the U.S. Bankruptcy Code, CalPERS contracts with cities can also be canceled.

As in the Detroit bankruptcy, Stockton's bankruptcy has placed public-pension advocates against investors, who stand to get mere pennies on the dollar for their bonds. Despite the judge concluding Stockton can cancel the CalPERS contract, the city still can convince him the plan should be approved. Judge Klein has said previously if he ruled against CalPERS, he may still approve Stockton's proposal.

Puerto Rico Update

Puerto Rico continues to make headlines, with APA acknowledging it is a very troubled credit. Puerto Rico's underlying problems are well documented and include: a high unemployment rate of 13.5% as of August 2014, a high poverty rate of 45% compared to the U.S. average of 14.9%, population loss of 5% in 2013 since 2000, challenged financial operations, and an underfunded pension system. The Commonwealth and its agencies debt levels are also very high, with approximately $73 billion of debt, the third highest behind California and New York. All of the recent actions in Puerto Rico are doing little to address underlying weak economic fundamentals.

Recently, it was disclosed that bondholders in possession of approximately 60% of Puerto Rico Electric Power Authority (PREPA) bonds signed non-disclosure agreements (NDA). After signing the NDAs, investors are provided with confidential information such as monthly cash statements and financing plans from PREPA not made available to the public. The NDAs come with restrictions including allowing only investors who signed an NDA to sell to other bondholders in the group or to investors who agree to sign an NDA. Recent price estimates show PREPA bonds with a July 2040 maturity trading at an average price of between 51 to 56 cents on the dollar, up from below 50 cents at the start of the August.

Puerto Rico is now attempting to sell a $1.2 billion note and subject it to New York law, in an effort to quell investor concerns on the mainland. If passed, the law would allow investors to sue under New York law in the event of any litigation related to the deal. The legislation is seen as providing additional protection for investors, who may be wary of lending to Puerto Rico after their move to restructure the Puerto Rico Electric Power Authority, which has over $9 billion in outstanding debt. The deal is expected to be privately placed with lenders including various hedge funds, J.P. Morgan Chase, Bank of America, and Morgan Stanley. The debt would mature in June 2015 and pay 7.75% interest. This would be the first deal for Puerto Rico since they passed legislation to restructure debt back in June.

The private placement note sale demonstrates how the investor base for Puerto Rico's debt has changed since 2012, as traditional municipal bond investors have generally stayed away from the troubled credit. UBS reports hedge funds are now the leading investor in PREPA bonds with a 39% ownership, while 24% of the debt is owned by individual investors.

Final Thoughts

Reducing Equity Portfolio Volatility With Bonds

In a recent analysis by Jason Draut, Senior Portfolio Manager of Wynn Capital Management, he used long term treasuries to reduce overall volatility of an all equity portfolio; he found that adding treasuries not only reduced volatility but actually produced better returns. Back dating returns to 1992, he used long treasuries (TLT) and the S&P 500. Having allocation models of 60/40 and 80/20 stocks to bonds mix and rebalancing at the end of each year, the returns, volatility and maximum drawdowns were as follows:

	Returns	Volatility	Maximum Drawdown
100% Stock	9.5%	14.7%	50.9%
60/40	9.8%	9.1%	24.7%
80/20	9.8%	11.3%	38.2%

Source: Wynn Capital Management

Mr. Draut lists two reasons for the better returns: 1) using negatively correlated assets, and 2) rebalancing once a year.

At the end of each year, the negative correlated assets should produce a winner and a loser, a fairly simple process where you are selling assets at a premium and buying the other asset at a discount.

A couple of caveats about the period from 1992 to present may interest you:

1.Treasury bond yields were about 7.80%; yields are 3% plus today.
2. Equities produced low returns for long stretches of time, but the discipline of rebalancing kept you invested in an asset class that was out of favor, no matter how negative the news was during those difficult times.

However, trying to predict returns on either of these asset classes is extremely difficult. What seems apparent from his analysis is implementation of diversification, discipline and periodic rebalancing adds significant value to investment portfolios. For more information, visit http://seekingalpha.com/article/2497615-diversification-at-its-best.

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