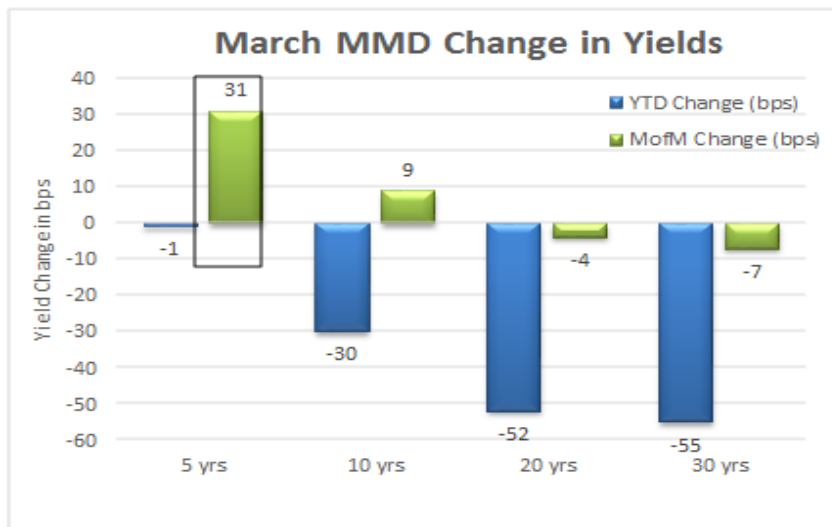


## Trading Markets

### Yellen Speaks, Market Reacts

The Federal Reserve Chairman, Janet Yellen, indicated at a press-conference on March 19th, that the Fed could start raising interest rates as soon as six months after it was done winding down the quantitative easing (QE) program. Her comments, coupled with current economic data, led to a significant flattening of the municipal yield curve during the month of March. The 5YR AAA MMD scale ended the month 31 basis points (bps) higher from February, while the 30YR MMD moved down 7 bps. 2014 started with one of the steepest yield curves in recent memory and year-to-date (YTD) the 5YR muni is down 1 bps, while the 30YR is yielding 55 bps lower. APA maintains that this trend will continue and the muni curve will likely flatten over the next 12 to 24 months. Specifically, we believe the 4 to 8 year part of the curve will continue to underperform; therefore we continue to advocate for a barbell strategy approach when structuring portfolios.

Demand remains strong for municipals, indicated by positive inflows into muni mutual funds and ETFs for the third consecutive month. Paired with the additional steady demand from individual investors seeking tax free income, total returns were positive for the first quarter of 2014. Municipal supply in March was a little more than 27 billion, which is close to historical averages. Puerto Rico was the biggest news maker of the month; the Commonwealth deal contributed to the tightening of lower-rated credit spreads. APA recommends adding some additional credit risk (particularly in the A rated category) on the long end of investor portfolios to pick up additional yield as the best defense in a flattening yield curve environment.



*"In determining how long to maintain the current...range for the federal fund rate, it [the Committee] will assess progress - both realized and expected - toward its objectives of maximum employment and 2 percent inflation."*

*Federal Reserve Chair*

*Janet Yellen,*

*March 19th, 2014*

### In This Issue

- Yellen's Comments
- Insurers Upgraded
- Puerto Rico Deal Recap
- NFP Hospital Issuance
- Credits to Watch
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# S&P Upgrades Two Insurers

Both Assured Guaranty (AGO) and National Public Finance/MBIA (NFPF) were upgraded by S&P in March and assigned stable outlooks. The rating agency now rates five of eight rated insurers in the "AA" rating category.

Assured was the only municipal insurer to continue operating through the 2008 financial crisis. S&P stated that they believe "Assured's competitive position remains strong relative to its peers' in the bond insurance industry." Additionally, they indicated that the insurer's timely payments during high profile defaults in 2013 lent to its business credibility.

As for NFPF, S&P noted that NFPF is "poised to join buy-rated AGO and BAM as the only active bond insurers." National has indicated that it may take some time for their business unit to ramp up.

The upgrades led to credit default swaps on the two firms to plunge to their lowest point in 6 months echoing S&P's sentiments that investor confidence may have returned to the bond insurers.

Moody's ratings on the two insurers are current as of January 2013 and they have not indicated they would upgrade in the near future.

Municipal Bond Insurer Ratings		
Insurer	Moody's	S & P
Berkshire Hathaway	Aa1/Stable	AA+/Negative
Build America Mutual (BAM)	Not Rated	AA/Stable
Assured Guaranty (AGO)	A3/Stable	AA/Stable
Assured Guaranty Municipal (AGM)	A2/Stable	AA/Stable
National Public Finance Guarantee (MBIA Illinois)	Baa1/Positive	AA-/Stable
MBIA	B3/Positive	A-/Stable
Radian	Baa1/Negative	B+/Negative
MBIA	B3/POS	A-/Stable
Syncora	Rating Withdrawn	Rating Withdrawn
Ambac	Rating Withdrawn	Rating Withdrawn
FGIC	Rating Withdrawn	Rating Withdrawn
CIFG	Rating Withdrawn	Rating Withdrawn
ACA	Rating Withdrawn	Rating Withdrawn

Source: Bloomberg, S&P, Moody's

## Credit Markets

### Puerto Rico Came to Market

Investor demand for the Commonwealth's recent General Obligation bond offering was so unprecedented that the deal was upsized from \$3 billion to \$3.5 billion prior to coming to market. Even with the additional supply, the deal remained over-subscribed by 4.5x with orders from over 270 different accounts. Bonds were issued at an 8% coupon, yielding 8.727%, maturing in 2035, which was well below speculation that Puerto Rico would have to pay investors a 10% or above coupon. Governor Alejandro Garcia Padilla touted the bond sale as a great success and pledged to submit a balanced budget, without lay-offs, while boosting overall economic development. Despite the successful deal, most municipal analysts remain skeptical of Puerto Rico's long term credit profile.

Post-issuance, the Financial Industry Regulatory Authority (FINRA) has announced they are examining the secondary trading of the bonds purchased in the deal. Due to the Commonwealth's junk rating, the prospectus stipulated that the debt would be issued in minimum denominations of \$100,000 and they could not be traded in smaller denominations until the credit rating of Puerto Rico was upgraded from junk by at least one rating agency. The main intent of the clause in the OS was to preclude broker-dealers from selling the bonds to retail investors who may not have the appropriate risk appetite for Puerto Rican debt. According to the Bond Buyer, approximately 70 transactions were executed in smaller denominations (some as low as \$5,000) on March 11th. While the minimum denomination provision was novel, the broker-dealers involved were still required to comply with the OS. In the coming months the market will be watching for future updates from FINRA regarding the investigation.

# NFP Hospital Issuance Declines

Despite historic low rates in the municipal market, creating an advantageous environment for issuers to issue additional debt, the Not-for-Profit Hospital sector has actually seen a decline in tax-exempt debt issuance over the last two years. According to Reuters, tax-exempt hospital debt issuance declined 25% in 2013, while Bloomberg data indicates issuance in the sector is down 50% year-over-year in the first quarter of 2014.

APA believes there are several reasons for the decline of issuance mostly related to individual issuer’s management teams taking a more conservative approach to funding large capital projects. Inpatient volumes have declined in recent years, as more patients and doctors opt for out-patient care, driving management to postpone large projects until revenue streams stabilize. Additionally, higher investment returns in 2013 have allowed hospitals to build up large cash reserves and fund projects such as medical record keeping systems with cash instead of new debt. Continued concern over the implementation of the Affordable Care Act (ACA) and uncertainty around possible reductions to reimbursements in addition to Medicare reductions also fuel this more conservative trend. Lastly, there has been slight increase in the issuance of taxable debt by large hospitals which is also likely contributing to the decline. (Taxable debt often has lower issuance costs, fewer disclosure requirements and greater flexibility of the use of bond proceeds.)

The chart below shows key credit fundamental medians over time. Days Cash on Hand (DCOH) improved from 118 days in 2008 to 184 DCOH for those hospitals that have issued audits for 2013. Debt levels have declined slightly in 2012 and 2013, with Long Term Debt to Capitalization (LTD to CAP) 35% in 2013, down from 39% in 2008. Meanwhile, age of property has increased to 10.5 years in 2013 from 10 years in 2008, evidencing the delay in debt issuance. We expect the trend to continue in the near term as health system management teams proceed with caution in the current operating environment.

# Muni Events to Watch:

- The **Detroit, MI** bankruptcy saga continues on with the most recent plan of adjustment submitted to the court on March 31st offering GO bondholders only 15 cents on the dollar. The 85% haircut on GO debt is the latest plan which now includes two classes of OPEB obligations. The city has stated they continue to amend the debt plan and will likely update it again, ahead of a hearing scheduled for April 14th.
- **Chicago, IL** is gearing up for a \$1 billion water/sewer revenue bond issuance. The bonds are currently rated a notch above the city’s GO rating. However, the system is so closely tied to the city’s finances that Moody’s downgraded the system’s bonds in March when they downgraded the city’s GO to Baa1 due to ongoing pension underfunding issues.
- The legislature of **Rhode Island** is once again toying with the notion of defaulting on the “38 Studio” debt service backed by a moral obligation pledge from the state. The debt is related to a failed economic development project which requires a \$12 million payment in the 2014 budget. Last year, lawmakers eventually appropriated for the debt service in the budget; however, the payment was only a \$2 million line item. If they choose to default on the bonds, Rhode Island would be the first state since the Great Depression to default on a payment to bondholders.

Key Median Hospital Ratios						
	2008	2009	2010	2011	2012	2013
Days Cash on hand	118	126	140	148	178	184
LTD to CAP	39.28	38.5	38.81	38.48	37.83	35.02
Debt Service Coverage	2.94	2.83	3.23	3.19	3.22	3.67
Operating Margin	0.6	1.2	0.92	1.13	1.14	1.1
Profit Margin	2.85	2.16	3.29	3.52	3.44	3.65
Age of Plant (years)	10	10.1	10.3	10.7	10.7	10.5

Source: Merritt Research Services, LLC/CreditScope

# Final Thoughts

## Rumors of the death of bonds have been greatly exaggerated

Bond market volatility has been extreme in the last year, with big swings both up and down. The negative returns for most municipal sectors during 2013 have been erased in the first quarter of 2014, as the market posted positive returns. Needless to say, many investors who have maintained an allocation to bonds in their investment portfolio have questioned why they should keep their fixed income positions. APA believes that bonds, especially intermediate investment grade bonds, will provide a buffer when the equity markets cycle down. Since 2009, the sages of Wall Street and talking heads on TV have been forecasting higher interest rates and higher inflation. However, what has actually transpired, has been almost the exact opposite; rather, we have been in a persistent low interest rate and low inflation rate environment. We consider it likely that at some point in the near to intermediate future interest rates will begin to move higher. However, as the economy is recovering slowly from the "Great Recession" we believe this will be a slow and gradual process. In the meantime, we believe bonds remain an important part of any diversified investment portfolio.

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