Municipal Market Comments

Ascent Investment Partners

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2013 Muni Market Review and 2014 Outlook

Municipal market performance in 2013 could be clearly split into two halves: before and after the May Fed meeting. Prior to late May, intermediate and long-term market rates had been trending downward, supported by the assumption that the Fed would continue its unprecedented policy of monetary stimulus (essentially zero percent interest rates combined with $85 billion per month of bond purchases) well into 2015. Following the May Fed meeting and Chairman Bernanke's comments hinting at tapering of quantitative easing (QE) purchases, yields leaped higher. Municipal market rates ended 2013 substantially higher than they began, and far higher than the May lows. Among the key drivers of the municipal market in 2013 were:

- The year began with uncertainty over funding of the federal budget and fears of the impact of the automatic budget cuts (the "sequester"). Fears of potential tax law changes and negative impacts on state and local budgets also helped push rates higher into year-end 2012 and through the initial weeks of 2013. Ultimately, however, federal budget impacts did not create any persistent negative pressure on the market.
- Following the Fed's discussion of tapering of its QE program in late May, bond yields spiked dramatically over the next 30 days, with yields on intermediate and long-term taxable and tax exempt bonds jumping more than 100 basis points (100 bps, or 1.00%) in many maturities.
- Perception of growing credit risk in municipals was driven by the bankruptcy filing of Detroit at the end of May. The continued weakening of the ratings of the State of Illinois and its Chicagoland credits due to persistent pension funding problems added additional credit concerns. Concurrently, the market experienced a dramatic sell-off in Puerto Rico bonds triggered by concerns that the island's credit rating could drop below investment-grade.
- Also driving municipal bond weakness was a dramatic shift in bond mutual fund flows. Strongly negative fund outflows in the second half of the year were driven by investors' fear of rising rates following Fed tapering. This created a negative loop in which funds were forced to sell long-term holdings, driving prices down and yields higher.
- The muni market bottomed in early September, with yields compared to late May levels more than 75 bps higher in five-year maturities, more than 100bps higher seven years and beyond and reaching more than 150bps higher on the long end (25-30 years).

- As rates rose, issuers were less able to refund outstanding bonds yields that provided interest cost savings. Consequently, much of the refunding volume that had been supporting issuance levels in 2013 began to dry up. As a result, municipal issuance slowed dramatically in the 3rd and 4th quarters (by as much as 33% for some monthly periods).
- In November and December, individual investors began to come back to the relatively attractive yields available in tax-exempt bonds. The combination of low supply and increasing demand led to a tightening in muni spreads relative to other fixed-income products.
- However, the year finished with a fresh wave of selling, as the December announcement of Fed tapering pressured all bonds' prices.

Despite the headline coverage of Detroit, Puerto Rico, Jefferson County and other bankrupt or distressed municipal issuers, the overall credit trend in the municipal marketplace has turned slightly positive. For the past few years, downgrades have greatly outnumbered upgrades. In 2013, however, S&P upgrades far outnumbered downgrades even before the new G.O. criteria (see below), while Moody's returned to a more neutral upgrade/downgrade ratio. Other tangible indications of a positive credit trend include:

- Moody's revised its outlook on the U.S. states sector to stable from negative this summer.
- In December, Moody's revised its outlook on the U.S. local governments sector (cities, counties, school districts, etc.) to stable from negative.
- In August, S&P began rolling out its new general obligation bond rating criteria for local governments. S&P expects that once the new criteria are fully implemented, approximately 25% of S&P rated G.O.s will receive one-notch upgrades while approximately 10% of S&P G.O. ratings are expected to be downgraded by one notch.

Looking Ahead to 2014

With macro issues on the Federal level much more settled than at this time last year, we expect bond markets in 2014 will be driven largely by investor expectations of Fed actions and, to a lesser degree, by economic fundamentals. A few of the themes we expect to dominate municipal markets in 2014 include:

- The Fed will continue to drive the fixed income markets. Investors' reactions to the pace of QE tapering will likely ratchet rates higher in maturities beyond three years. While we do expect the overall trend in rates to be higher, we anticipate a great deal of volatility over the course of 2014.
- With short-term rates effectively anchored at zero for the near future, we anticipate yield changes will be reflected in further steepening of the curve.

- As a result, income-focused investors with a well-laddered portfolio will have increasing opportunities to "dollar cost average" into higher yielding bonds by rolling maturing bond proceeds into intermediate maturities (three to seven years) at increasingly attractive rates.
- Higher nominal yields may begin to attract investors back to traditional fixed-income markets from higher yielding (and higher risk) alternative income products.
- As rates rise, we expect issuance to drop as refunding opportunities diminish. Some market observers predict that 2014 could see the lowest level of municipal issuance in the past 10 years. Such a lack of supply should help support prices.
- As the effects of new investment taxes are felt, there could be increasing demand for tax-exempt investments.
- Developments with Detroit's bankruptcy, Puerto Rico's credit rating and Illinois' pension funding legislation could drive investor perception of credit risk in the market in either direction. While we continue to see the overall trend in credit as slightly positive, headline events will continue to drive investor sentiment.

Our perspective continues to be that a sound fundamental approach to fixed-income investing, based on careful credit selection and thoughtful portfolio structure, will provide solid return opportunities. Rising rates are a positive for investors that can take advantage of the potential to increase income generation while still remaining conservatively positioned against market and credit risk.

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