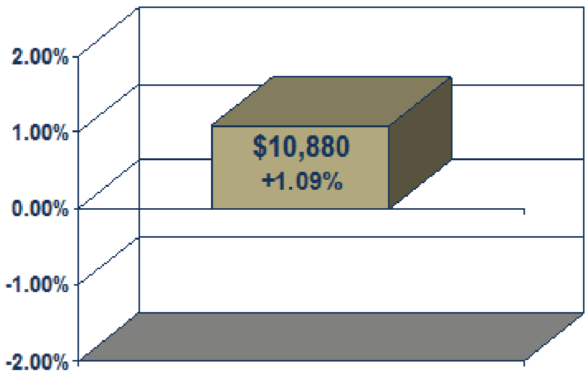
Rates Matter (2/5/2018)

Thus far, 2018 has been a challenging year for tax-exempt bond investors. Last week was particularly difficult as we witnessed asset prices fall in virtually all asset classes: stocks, metals, U.S. dollar, global debt including U.S. Treasury, municipal, and corporate debt. While our shorter than usual duration (measurement of interest rate sensitivity) positioning has lessened the declines in the market values of our client portfolios, at the end of the day we are invested in a market. As is the case with all liquid assets, prices continuously fluctuate. In the case of municipal bonds, the variations are often tethered to the yield and price changes witnessed in the U.S. Treasury bond market.

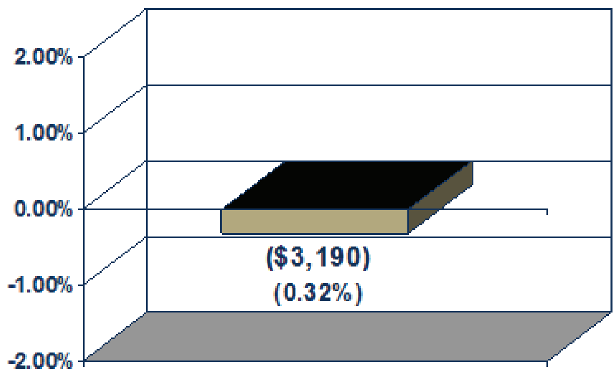
With respect to the elevated levels of interest rates, in our Third Quarter 2017 Commentary, we explained the following: “our continued view is that there are self-breaking mechanisms in place, which structurally prevent yields from rising dramatically, in any sustainable way. Simply put, our economy is dependent on low U.S. Treasury interest rates and narrow credit quality spreads for issuers of debt obligations. Should yields rise precipitously, borrowing will become more expensive, and risk assets of all stripes should be re-priced. As in the past, this event should act as a natural brake on economic activity and could easily intensify the economic fractures that have already begun to appear”.

As we entered the year, we held the view that 10- year U.S. Treasury bond yields could reach 2.90%. While we are close to that level, and tempted to materially alter our current defensive stance, we will remain cautious. Before we can conclude there has been a long-term shift in the repricing of riskier assets and the potential to detract from economic activity, a trend needs to be established. A week does not a trend make!

In addition, to date, the performance of bond portfolios have come under additional pressure as the rise in market yields (lower prices) has occurred swiftly. Over time, the receipt of an additional 11 months of tax-exempt cash flow should serve to buffer portfolios against continued interest rate volatility. The hypothetical analysis highlighted below, displays the anticipated changes in the market value of a $1 million Market Duration portfolio assuming market yields change by 50 and 100 basis points (1/2% and 1% respectively) over a 12-month period.



Market Yields Rise By 0.50%



Market Yields Rise by 1.00%

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