Weathering the Storm (9/6/13)

Interest rates are standing at a crossroads, as current market valuations seem to be driven more by technical factors than economic fundamentals.

- The month of August continued to provide additional volatility and disappointing results for existing municipal bond portfolios.
- The poor municipal bond market performance can best be illustrated by examining the total rate of return of the broadest municipal bond index (Barclays Capital Municipal Bond Index), which declined (-1.43%) for the month.
- While we recognize the decline in valuations that our clients are experiencing in their existing holdings is painful, our strategy and defensive posture has allowed us to weather the storm relatively well with respect to our peers.
- As we communicated previously, statements by Fed Chairman Bernanke can be credited with starting the trend toward higher interest rates by commenting about Fed plans to "taper" future government bond purchases.
- These comments tripped massive selling pressure from holders such as mutual funds, hedge funds, and Treasury holdings by foreign central banks.
- Bond funds in general have experienced huge outflows, but municipal bond funds have experienced the greatest redemptions. In fact, the dollar amount now fleeing municipal funds exceeds that of the "Meredith Whitney period" in 2010.
- Given the sheer size of securities being sold, what began as a deleveraging of positions, has morphed into a liquidity event.
- It appears that the interest rate markets have entered a deleveraging cycle whereby fear has taken over, and selling begets selling.

- Thus far, Investment Banks (Broker/Dealers) have shown a reluctance to risk their firm's capital by adding positions to their inventory in a highly volatile and politically charged environment.

- This is how deleveraging, and/or illiquidity, has looked in the past (i.e. 1994, 1999, 2008, 2010), and only ended with yields "overshooting" our expectations for both time and price.

At present, we are monitoring signs that the current trend will reverse to capitalize on such an opportunity, but we are very respectful of the dynamics mentioned above. Technical forces are more challenging to "handicap" than fundamental ones as recent history demonstrates.

Robert S. Waas Managing Member	Robert K. Coates Senior Portfolio Manager	Matthew T. Werner Portfolio Manager	Mark J. Tenenhaus Director of Municipal Research	John A. Carlson Director of Business Development	Marites V. Pasturan Data Analyst	Randy J. Fox Operations Associate	Brian E. Pawl Operations Associate	Irina R. Brooklier Client Service Assistant