Here We Go…or Here We Go Again?

As we enter Spring 2012, a familiar pattern is materializing in financial markets. For the third time in as many years, we are witnessing equity market momentum, improving economic data, and amplifying interest rate fears. And the question has re-emerged: Are the financial markets finally setting the stage for a long-term recovery and a prolonged adjustment towards higher interest rates, or will this just be the most recent in a series of “head-fakes?”

In late-April 2010 the Dow Jones Industrial Average finished a three-month, 1,200-point rally that left the index at its highest point in 18 months. Better U.S. economic data, improving corporate health, and an accommodative Fed boosted hopes that the U.S. was at the beginning of a sustainable recovery period and that the worst of the recession was in the past. Administration officials launched their famous “Recovery Summer” campaign, but the markets refused to cooperate. By mid-May much of the optimism had faded, and the Dow had plummeted over 1,000 points on fears fueled by a series of events: the then- (and still to the dissatisfaction of many) unexplained “flash crash” in the U.S. stock markets, European political and financial turmoil, and the Deepwater Horizon oil spill in the Gulf of Mexico. These events ignited a powerful flight-to-quality that persisted into October of that year, pushing yields on U.S. government debt to their lowest levels since the worst of the financial crisis.

Markets eventually found equilibrium, and the first several months of 2011 witnessed the return of a more positive outlook, both in the United States and abroad. The Federal Reserve’s execution of QE2 flooded the market with continued liquidity, supporting asset prices. Economic data showed...
signs of improvement, equity markets rallied and the fear of rising interest rates re-emerged. However, volatility and uncertainty began to resurface through the early summer as renewed concerns about Greek solvency, Middle East political unrest, rising oil prices and uncertain fallout from the massive earthquake in Japan shook investor confidence. Positive trends in economic data showed signs of rolling back over, particularly for the continuously challenged housing market. This wall of worry became too much for the markets to bear in August 2011 when Congress and the President could not come to terms on a meaningful resolution to the debt ceiling debate. The subsequent downgrade in the U.S. credit rating ignited a severe “risk-off” trade, with investors fleeing from just about all risk assets and flocking into U.S. Treasuries, which despite the downgrade proved themselves still the favored flight to quality vehicle.

So will the third time prove to be the sustainable recovery charm, or are the markets just setting up for the next “risk-off” trade? We view the current equity rally and weakening in the U.S. debt markets as a healthy reflection of a U.S. economy that is off the mat from last fall when forecasters whispered of “double-dips” and “QE3.” The current near-term stability has proven self-fulfilling, providing a nurturing environment for the “risk-on” bias. However, several headwinds and uncertainties still lay ahead – enough to prevent us from forecasting that the recent jump in interest rates marks the beginning of the next big rate cycle. Although improving, unemployment still hovers at a very high level (8.3%), not conducive towards growth. Commodity prices (namely oil) have escalated in recent weeks - in part due to an increased risk of conflict in the Middle East that potentially threatens the world’s oil supply chain; recall that higher gasoline prices were somewhat blamed for choking off hopes of a sustainable recovery in 2011. We further believe that, although a disorderly default is unlikely in Greece, the Eurozone’s fiscal troubles are far from resolved as other heavily indebted countries in the region may demand market attention (i.e. Italy). Finally, we believe that the U.S. housing market remains mired in lingering structural challenges. As market interest rates increase even slightly, the exponential impact on home affordability may further challenge a market that continues to face high inventory and elevated foreclosure rates.

The economy appears to be improving, albeit more slowly than most would prefer, but favorably versus Europe and Asia. As we compare today’s market to recent false-starts, the notable difference has been the prolonged absence of the kinds of confidence-shaking events that have derailed previous market momentum. Momentum has proven to be a powerful market force over the past few years, and it likely continues the current “risk-on” rally until the next confidence-shaking event. However, we interpret that near-term economic conditions continue to pose a cap on the trajectory and sustainability of the current rise in rates, leading us to believe we have not started a prolonged increase in yields. So long as inflationary pressures remain muted as measured by the Fed, we expect the Fed to focus on the still-high level of unemployment and to remain accommodative.

The risk to our outlook is if current trends and optimism actually reflect more of a sustainable recovery than we expect, eventually feeding into inflationary pressures. If the rate markets start to trade on longer term inflationary concerns rather than the shorter term dictation from the Fed, we may see further vulnerability in rates, particularly for more intermediate and longer dated fixed income instruments.
Muni Market Dynamics

At the end of January, Muni yields tested all-time lows as persistent demand far outweighed extremely low available supply. We have discussed ad nauseam the paltry issuance volume in 2011 largely due to more austere budgeting practices among state and local municipalities. However, all-time low borrowing costs became too attractive for many issuers to ignore, as borrowers began announcing refunding plans (retiring existing debt in favor of issuing new debt at lower interest rates) and new supply that had been tabled over the past year. As 30-day visible supply began to grow in February, reaching new highs each week, Muni yields began to give way, taking upward direction from the Treasury market. As of this writing, the 10-Year AAA MMD yield spot has risen almost 70 basis points since the end of January. Much of the pent up-demand has been satisfied, and dealers have lightened inventory. Recent new deals did very well in general, which may seem counterintuitive given the back-up in yields. A good portion of the sell-off was more in response to the Treasury market weakness seen in February and early-March than any large concessions being priced in to deals to achieve distribution. Though some issuers were forced to bring deals at levels that were slightly wider than recent lows, those deals were in the minority. Over the past week, we have seen weekly and visible supply begin to trickle down to more manageable levels and Muni yields appearing to stabilize.

From a credit perspective, so far this year the dollar value of defaults is almost double the total seen in the same period in 2011 despite the actual number of defaults being fewer. Issuers in Stockton, CA, Hercules, CA, and Harrisburg, PA are the most recent to default on debt obligations while others, such as Suffolk Co, NY, have declared fiscal emergencies. These recent events reawakened some credit anxieties among participants that had been lulled to sleep by reports of improving revenue collections among state and local governments. We view these recent headlines in several ways: First, it should continue to serve as a reminder that “knowing what you own” must be at the forefront of Muni investors’ minds. Credit surveillance and prudent security selection remain paramount. Second, fiscal conditions in states, cities, and counties tend to lag widely circulated economic indicators. Though improving, municipalities will be feeling the pinch of the Great Recession for years to come. Last, Munis are a highly segregated asset class: Muni issuers represent distinct local governments, demographics, economies, and geographic locations. Revenue sources and pledges securing interest and principal payments to debt holders vary widely. Therefore, we continue to view defaults like those mentioned as isolated events and not part of a larger default trend or contagion of fiscal emergencies.

Caprin Portfolio Strategies

Across strategies, Caprin continues to manage durations slightly long of benchmarks in light of our current outlook and in response to the accommodative Fed, which reaffirmed its low-rate commitment for the foreseeable future and left its target rate unchanged (0-0.25%) at its last meeting.

Intermediate Muni (IM)

In late 2010, we began to place an emphasis on augmenting the yield in our IM portfolios through the addition of strong power, healthcare, housing, airport, and other higher-yielding sectors that would potentially combat the low yield environment and benefit from both low supply and modestly improving economic conditions. In recent weeks, the back-up in Muni yields and increased supply...
volume have restored some value to very high quality-type paper, especially in the 5-15 year maturity range. Whereas AAA-AA GO and revenue names became relatively expensive through the latter half of 2011, we are now seeing an increased number of opportunities to invest at more attractive yields. However, incorporating out-of-state exposure and strong, higher-yielding sectors remains a key component in meeting our clients’ income objectives while diversifying credit risk.

**Intermediate Taxable (IT)**
We remain overweight select corporate issuers (industrials, utilities, and finance), which are benefitting from the recent “risk-on” activity and the modestly improving U.S. economic landscape. Taxable municipal securities also continue to offer attractive risk-adjusted value opportunities.

**Short Maturity Muni (SMM)**
The rate environment at the front of the Muni curve remains challenging. We are committed in our pursuit of strong, liquid yield opportunities in the construction of diversified portfolios.

**Low Duration Taxable (LDT)**
While agencies currently provide the main liquidity and ratings-enhancement vehicle, we opportunistically purchase corporate debt offering attractive yields on a risk-adjusted basis. Furthermore, taxable and even traditional Munis provide us with a great tool for boosting income in LDT portfolios, allowing us to leverage our Muni research and trading expertise to the benefit of our taxable investors.

**Conclusion**
Revisiting our discussion of the interest rate environment, we always caution that predictions on interest rates are tenuous at best. The direction and timing of rates are subject to unknowable and unforeseeable circumstances and forces, and timing the rate markets is a challenging endeavor. The risk to being on the wrong side of a rate move can be costly, and therefore our market outlook must evolve as conditions change. As we began discussing last year, we recommend advisors take advantage of current market conditions to have conversations that confirm the role and strategy for the bond allocation within each client’s overall investment strategy. We are always happy to be a part of those conversations.

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