January
2014

2013 Municipal Market Review & Outlook

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Finally, the tapering debate as to when and by how much is over. On December 18th, the FOMC announced a $10 billion taper on its current $85 billion per month in asset purchasing. They will reduce both agency mortgage-backed securities and longer-term Treasuries by $5 billion per month. As most predicted, they neutralized market reaction by saying they would maintain the funds rate well past the time that the unemployment rate declines below 6.5%, especially if inflation is under their 2% goal. From here, the debate will shift to further reductions that should come in the form of "measured steps at future meetings". The following is our 2013 municipal market review and outlook. Our forward looking investment approach encompasses where we are and how we got here.

After a quiet first quarter, the Fed's tapering comments beginning in May resulted in rising yields (and falling prices) in all fixed-income sectors in the second quarter, but muni bonds were particularly hard hit. Muni yields (measured by 10-year AAA yields) were up nearly 60 basis points in the second quarter with lower ratings increasing more. Muni returns suffered their fourth worst quarterly loss in over two decades. The three worst periods occurred after Meredith Whitney's default comments, the market's collapse at the end of 2008, and Fed tightening in early 1994.

Muni bonds continued their selloff during August before recovering somewhat during September and October. November was uneventful despite continued withdrawals from municipal-bond mutual funds and recent data shows the largest outflows since August. As speculation mounted that the Fed was preparing to reduce its bond purchases, individuals withdrew $1.9 billion from muni funds last week, Lipper US Fund Flows data show. Outflows have tallied a record $57.5 billion this year, driving munis to their first annual loss since 2008.

The recent rise in interest rates is not impacting our overall fixed-income positioning, either on the taxable or tax-sensitive portfolios though we have lengthened duration slightly within our model portfolios. We have known that higher interest rates were possible for quite some time, though we never pretend to know when or by how much rates will increase. While this recent move in rates was volatile, our five-year scenario analysis has incorporated expectations for higher interest rates to varying degrees and our bond allocations include funds that can perform well in different economic environments. Predicting interest rates is hard, and poorly diversified portfolios or asset allocations that are structured to perform well in only one scenario have often led to poor performance.

We continue to recommend a tactical underweight to core bonds (muni and taxable), and an overweight to taxable absolute-return-oriented fixed-income and other alternative strategies. Fixed income examples include PIMCO Unconstrained and in our most-conservative portfolios, floating-rate loans, which can benefit from rising interest rates.

In terms of other ways to hedge interest rate risk in our portfolios, currently we are not interested in adding short-duration municipals. While they are less interest-rate sensitive, we don't think you are getting paid enough at current price levels as yields are below 1%. Nor do we want to venture into high-yield munis (particularly individual credits). We would rather take credit risk exposure within taxable funds such as the Loomis Sayles Bond, and given current valuations we do not think taking too much municipal credit risk is prudent.

As for our outlook, we continue to think the intermediate part of the muni curve is the most attractive part of the market. We have a bias towards bonds with defensive coupons of 4% or greater with a focus on premium callable municipals sometimes referred to as "cushion" or "kicker" bonds. Our performance themes continue to evolve around "rolling the steep yield curve" and opportunistic buying/selling within a somewhat volatile market. We will continue to evaluate our portfolio positioning, balancing risk and reward in a manner that is consistent with our longer-term investment discipline and our client's objectives. We frequently invest with active managers we think can add value relative to the muni benchmark particularly to create national exposure and diversification from our typical client's individual Kentucky positions. We believe that the soon to be apparent higher tax rates (including the new 3.8% Medicare Tax) and projected net negative supply should provide some tailwinds next year. In addition, historical yields vs. Treasuries (often converted into ratios) are attractive.

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A reduction in fund outflows would certainly be beneficial. The visible wild card for next year is Puerto Rico. While issuers' credit quality are broadly improving due to the recovery in the housing market and general economy, Puerto Rico, one of the largest issuers and widely held in funds, is an important exception. Its credit rating is the lowest investment-grade rating with Moody's/Fitch having it on negative watch and Standard & Poor's having a negative outlook. Any negative developments including a cut to junk status could lead to a period of risk-off sentiment for municipal bond markets. We would view such a period as a buying opportunity.

As for our Commonwealth, we were pleased to see Kentucky pass a pension reform bill in 2013. Moody's summarized the bill by saying "The extensive pension reform legislation uses a variety of methods to reduce long-term costs, including replacing Kentucky's defined benefit plan with a defined contribution plan for all state and local employees hired after 2013. The new law also requires the General Assembly to fully fund the actuarially required annual pension contribution and creates an annual revenue stream of almost $100 million to do so." Moody's concluded that "The measure is credit positive for the Commonwealth of Kentucky (Aa2 negative)." In contrast is a recent book entitled Kentucky Fried Pensions: A Culture of Cover-up and Corruption by Christopher B Tobe CFA. While we agree with many of his conclusions, we reiterate that these are long-term challenges and do not suggest an imminent "haircut" to bond prices and certainly not to redemption or par values.

Below are some excerpts (Bull/Bear) of 2014 Wall Street Outlook/Research to supplement our commentary above.

Bullish – A steepening yield curve that pushed the two- to 30-year slope to 370 basis points this year has left the long end of the market oversold, creating a buying opportunity in 2014, according to Philip Condon, head of U.S. fixed income and municipal bonds at Deutsche Asset and Wealth Management. A selloff this year pushed the 30-year yield up 139 basis points to 4.16% and the 20-year yield up 142 basis points to 3.87%. The 30-year muni yield to Treasury yield ratio currently sits at 107%. Longer maturing debt that sold off faster than shorter maturing bonds throughout 2013 will also hold up better when the Federal Reserve begins scaling back its $85 billion a month bond purchasing program, Condon said. Higher yields and higher taxes will spur demand for municipals in 2014 while overall net negative supply for what could be the fourth consecutive year will also help demand.

Bearish – Municipal bond investors will probably face negative returns in 2014 following declines this year, the first back-to-back annual losses since at least the 1980s, according to Morgan Stanley. The company's base-case scenario for city and state debt in 2014 calls for a loss of 1.7% to 4.1%, Michael Zezas, the bank's chief muni strategist, said in a report published in early December. A year ago, he correctly predicted that munis would lose money in 2013 as yields rose from the lowest since the 1960s. The municipal market declined about 2.7% this year through Dec. 2, on pace for the first drop since 2008, Bank of America Merrill Lynch data show. Another drop in 2014 would be unprecedented – muni debt has followed a year of losses with gains every year since at least 1989, when Bank of America data begin. "A painful 2013 yielded better valuations, but more must be endured before our outlook brightens," wrote Zezas. Munis are "disposed to negative returns and volatile liquidity as the economy improves and rates rise," he said. Morgan Stanley's most likely scenario assumes Treasury yields rise as the Federal Reserve tapers its monthly fixed-income purchases.

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