Chairman's Letter

By Charles "Skip" Fish, CEO and CIO

There were many dramatic events in 2015, but the movement in interest rates wasn't one of them. If you plot the AAA muni curve for 12-31-15 over one for 12-31-14, you can't tell them apart. The differences in yields between the end of 2014 and the end of 2015, at 5 year intervals, averaged a decline of only 4.8 basis points (.00048). For the record, the 10-year Treasury closed 2015 at 2.27%. It closed 2014 at 2.17%. Why did so many forecasts miss the mark so badly? Will they miss by as much in 2016?

In addition to the Fourth Estate's need to dramatize, the mainstream perception that lower unemployment leads to wage pressures, that in turn lead to increased inflation and higher interest rates persists. Recent history, however, has discredited this. In 2012, when unemployment was over 8%, inflation hit 2%. Now, with unemployment poised to drop below 5%, the inflation rate is below 2%. Clearly other factors need to be assigned greater weight. The true impact on the U.S. of global economic stresses needs to be evaluated far more closely. So should the distressing state of our domestic labor participation rate (LPR), which stands at a 39 year low. (Note that if the LPR today was as high as it was 15 years ago, our unemployment rate would be over 10%.)

As for municipal yields in 2016, CFI believes that the slight upward pressure on rates the Federal Reserve's actions produce will be largely offset by demographic and technical factors. It is likely that the supply of new bonds in 2016 will be less than in 2015. A substantial portion of the new debt will be used to call or advance refund older debt. Demand for munis, on the other hand, is rising and should continue to climb well into the future. An aging, more risk-averse population, a growing need for shelter from taxation and the falling into disfavor of other investment asset classes practically guarantees this.

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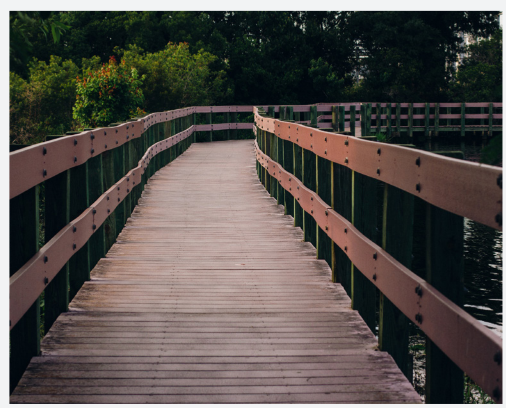
In This Issue

For the history buff in all of us…

In case you are wondering about the Fourth Estate and curious to know more about Estates One, Two and Three… The Fourth Estate most commonly refers to the news media, aka "the press". Attributed to Edmund Burke around 1787 as he referred to the traditional hierarchy of Clergy, Nobility and Commoners, respectively, existing in France before the French Revolution (1789-1799). Burke has been quoted as saying that the Fourth Estate, aka press, while not officially recognized at the time had far more importance than all.



"Year's end is neither an end nor a beginning but a going on, with all the wisdom experience can instill in us."

-Hal Borland

[1] Paraphrased from Wikipedia, referring to the book by Thomas Carlyle, "On Heros and Hero Worship".

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So where will 2016 end? In all likelihood, 2016 will end with higher yields on the front end (inside 5 years) and little change beyond that. This means a flatter yield curve (see CFI newsletter dated 8/6/15). It may sound boring, but it isn't really. Junk bonds and underfunded pensions will continue to garner the headlines. Success will be created by those willing to roll up their sleeves, operate in the secondary market, do their homework, unlock the hidden values of the non-rated sector, fully analyze callable bond opportunities, avoid junk bonds and stay ever vigilant, etc. This should sound very familiar to those of you who have been with CFI for some time.

All of us at CFI wish you and yours a healthy, happy New Year!

FISH SCALES

	1.13		2019	1.13	1.42	1.12	1.91	1.61	+64
	1.26		**2020**	**1.28**	**1.59**	**1.27**	**2.18**	**1.76**	**+78**
	1.39		2021	1.44	1.79		2.40	1.96	+79
	1.54		2022	1.62	1.97		2.61	2.09	+90
	1.68		2023	1.79	2.17		2.80	2.14	+99
	1.81		2024	1.95	2.31		2.92	2.25	+104
	1.92		**2025**	**2.10**	**2.44**		**3.05**	**2.27**	**+114**
	2.02		2026	2.25	2.64		3.23		
	2.10		2027	2.36	2.78		3.32		
	2.17		2028	2.47	2.88		3.39		
	2.24		2029	2.62	3.00		3.48		
	2.30		**2030**	**2.71**	**3.07**		**3.57**	**2.53**	**+145**
	2.55		**2035**	**2.87**	**3.34**		**3.90**	**2.68**	**+164**
	2.75		**2040**	**3.06**	**3.47**		**4.07**	**2.91**	**+163**
	2.82		**2045**	**3.20**	**3.64**		**4.18**	**3.02**	**+161**

** National Scales from MMD*
***Proxy for Non-Rated Paper*

December 31, 2015
AS OF DATE

Puerto Rico Recap: Some But Not All

By Betsy Shelton, Director of Research / Sr. Portfolio Manager.

On Monday, January 5th, the Commonwealth of Puerto Rico paid nearly $595 million in debt service due on 1-1-2016. Some payments were made by the drawdown on reserve funds while some from monies "clawed back" from other sources whose revenues had been dedicated to those bondholders.

Unfortunately, the Commonwealth defaulted on $37 million in interest payments owed by the Puerto Rico Infrastructure Finance Authority (PRIFA) ($35.9 million) and the Puerto Rico Finance Corporation (PRFC) ($1.4 million). Much to some bondholders' chagrin, the PRIFA trust indenture contains no language as to an event of default, leaving investors with the limited remedy of pursuing legal enforcement of their rights. Bond insurers have picked up some of the delinquency ($10 million). However, insurers continue to contest the government's diversion of revenues to pay not only essential services (a move we can understand even if we disagree on it) and to award $120 million in Christmas bonuses (an action we consider totally unacceptable in light of the present circumstances).

Congress, at long last, has taken up the gauntlet in response to Puerto Rico's cry for assistance and long-needed overhaul of the Commonwealth's infrastructure. Given the historic snail's pace of the federal government (only just now has Congress announced hearings on the crisis will begin in February) and the distractions of an election year, the likelihood of any meaningful action in the near term would appear to be more of a pipe dream than any sort of a shoo-in. The only winners right now are the lawyers who will be having a heyday "duking" matters out in court for some time to come.

There was a time when such events would have roiled the markets for days, even weeks and months. Remember the WPPSS default in 1984? Contrast that with today's environment where the market just seems to roll along with a ho-hum attitude. Have we become so desensitized to the lack of political will to pay as to think it is business as usual? Or instead has the plethora of modern communications allowed investors access to information and early warning signs not previously available and thus be able to prepare, for better or worse? I think it is a little of each. Certainly astute investors over the last year or so have had plenty of data to indicate it was time to get out of their Puerto Rico holdings. For those that choose, either overtly or through a proxy (i.e. mutual fund) not to exit this market, suffering the consequences of inaction will surely haunt them in the days ahead. The roller coast ride in Commonwealth bond prices that began almost four years ago will likely continue and any ultimate recoveries will most likely be just pennies on the dollar.

Now for the good news. Overall the municipal market has shaken off Puerto Rico's default as an isolated situation. The market's optimism is due primarily to the improving finances of most other state and local governments coupled with more investors seeking to participate in what some say is today's portfolio "sweet spot". Bloomberg News reports that the "January effect lives on, as municipal bond funds flush with cash." [1]

From a credit perspective, 2016 will likely be a pivotal one for most market participants. With the implementation of the best execution rule (MSRB Rule G-18), the small investor will, hopefully, gain access to a more level playing field, at least when it comes to transactions. Disclosures under GASB 67 & 68 are now commonplace in most issuer financial filings, revealing pension and OPEB liabilities previously hidden to layman eyes, and soon-to-be mandated price transparency protocols should significantly improve the valuation process.

It goes without saying that the best way to dodge a bullet is to not be its line of fire. Should one find oneself in such a situation, having sufficient reaction time is a crucial component to survival. The advances

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[1] **Bloomberg News,** January 5, 2016

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in disclosure measures over the past few years have provided sufficient time for investors to dodge potential credit challenges to say nothing of the recent defaults (Stockton, Detroit, San Bernardino, Puerto Rico, etc.). Going forward, pension reform will likely dominate municipal credit headlines including the possible further credit downgrades to Illinois, New Jersey and other pension-strapped state governments. Conflicting court rulings on voter reform initiatives (i.e. City of San Diego) will also create uncertainty in this sector. Likewise the oil-price tumble has caused significant revenue shortfall in many states including Alaska, Texas, and Oklahoma. Investors can expect more headline news as these states will struggle to adopt unprecedented measures in order to repair their respective state budgets. These two sectors aside, the market overall is expected to be a year of benign credit issues. But one should not become comfortable when it comes to credit analysis despite the improved environment. We all need to be reminded periodically that complacency often underestimates the risks and obscures the need to be constantly vigilant.

I have been encouraged by the formation of a multi-faceted group of market professionals in response to MCDC [2] and the MSRB's creation of the Investor Advisory Group[3] along with improved state communication tools like California's Debtwatch[4] rolled out late last year by the Treasurer's Office. These collective efforts should help to bring more transparency about issuance, consistency in loan documents, and relevant and productive self-imposed regulations. Therefore, as we say farewell to 2015, we raise a toast to 2016 that it may be a year of cooperation, accountability and practical innovation.

For more information visit

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to schedule a private consultation.

[2] **The Bond Buyer,** December 31, 2015
[3] Municipal Securities Rulemaking Board, Press Release, September 17, 2015
[4] **The Bond Buyer,** November 17, 2015