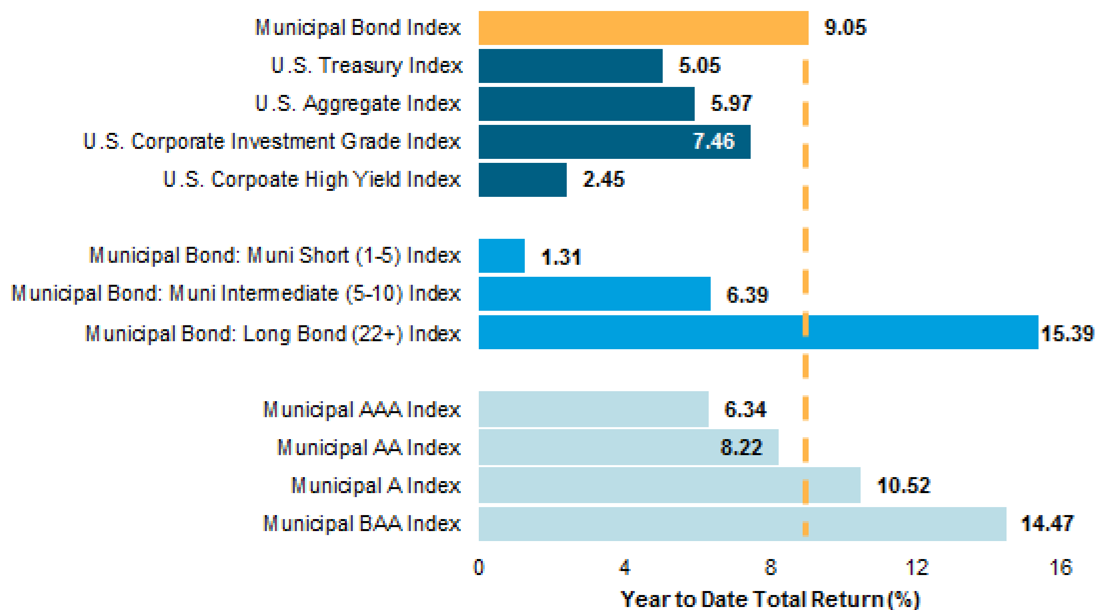
Market Comment 2/12/15

Munis Looking Good, But Can They Repeat?

2014: A Tough Act to Follow:

Last year began with a familiar consensus in the financial markets. The prevailing negative sentiment about the prospect for fixed income performance in 2014 was widely accepted. It was to be the end of the bull market in bonds. How did that play out? The yield on the UST 10yr was 87 basis points lower by December 31, 2014. Ten year AAA municipal bond yields were 73 basis points lower, according to Municipal Market Data (MMD). Slow global economic growth, signs of European deflation, conflicts abroad and a friendly Fed gave U.S. Treasury's a lift. Tight supply, higher taxes, fund inflows and improving fiscal conditions further propelled muni performance. The Barclays Municipal Bond Index returned 9.05% in 2014. And according to Barclays, munis returned 13.1% when adjusted for taxes.

The positive dynamics that played out in the 2014 muni market were a sharp reversal of 2013's challenges. Long duration and high yield were the best performers. Investors set records as they bailed out of muni bond mutual funds in 2013, but fund inflows were $32 billion last year, according to Morningstar. More than $10 billion of that inflow occurred in fourth quarter. Many property and casualty insurance companies returned to the market as well.



Source: Barclays, as of 12/31/2014. Indexes represented are: Barclays Municipal Bond Index, Barclays U.S. Treasury Bond Index, Barclays U.S. Aggregate Index, Barclays U.S. Corporate Investment Grade Bond Index, and Barclays U.S. Corporate High-Yield Bond Index. The short, intermediate, long, AAA, AA, A, and BAA municipal indexes are all sub-indexes of the Municipal Bond index.

2015: A Tale of Two Markets

This year began with another downbeat forecast for bonds. Anticipated mid-2015 Fed rate hikes were expected to produce mediocre returns in fixed income markets. The dismal outlook was turned upside down in January, as the ten year UST rallied fifty basis points. The oil selloff and indications of a slowdown in key economies around the world weighed on equities and unleashed a fierce bond rally. Munis followed in the dramatic uptrade.

So far, February has been a very different story. UST's and munis have retraced all of January's gains, and then some. The yield curve has steepened, particularly out longer. Credit spreads have widened. It's certainly not a panic at this point, but the muni curve has been under pressure. Year-to-date new issue supply has been heavy. Current yields are notably higher, and attractive once again on a taxable equivalent basis.

Looking Ahead:

Yields have returned to 4Q 2014 levels. A steeper muni yield curve and wider spreads make munis worthy of consideration for income investors. And while a strengthening domestic economy may eventually lead to a further rise in interest rates, continued U.S. economic improvement will likely result in higher home prices, falling unemployment, growth in wages and stronger consumer spending. These are positive developments in terms of muni credit fundamentals as they benefit property, income, and sales tax collections. For example, last week the Rockefeller Institute of Government released it's State Revenue Report, which indicated overall growth in state tax revenues for 3Q14. Total taxes grew 4.4% year-over-year for 46 states that supplied data, showing gains in all tax sectors. The fiscal condition of most municipalities is the strongest it has been since the financial crisis of 2008. Total defaults in 2014 were around $1.15 billion, representing 0.031% of the market. In 2013, defaults were approximately $2.6 billion (still low at 0.076%).

Municipal new issuance is expected to rise slightly in 2015 to around $350 billion, given potential refunding activity and the backlog of infrastructure projects that are in many cases long overdue. Approximately $340 billion in existing securities will mature or will likely be called, resulting in a small net gain in bonds outstanding for the year. As usual, June, July and August appear to be the most promising months of potential muni performance. This period is heavy in terms of bond maturities, calls and coupon payments. The resulting proceeds are generally reinvested, keeping the market well bid.

Munis are well worth considering for investors in higher tax brackets seeking income. The current taxable equivalent yield on an A-rated 10-year municipal bond is approximately 3.75% for investors in the 28 percent federal tax bracket (single filers with taxable income of $189,000+ and married joint filers with income of $230,451+). For those in higher federal brackets, taxable equivalent yields are in the 3.90% to 4.25% range. These after tax yields are even more appealing if an investor can shield that income from state and local income tax. And better still for those who are subject to the 3.80% federal investment income tax (Affordable Care Act), given that municipal bond income is exempt from that health-care surtax.

Stay Calm and Take Advantage

Individuals (rather than institutions) represent a large proportion of municipal bond holders. Either through direct ownership of securities or via bond funds, retail investors hold more than 75% of outstanding municipal bonds. These investors also have a tendency to overreact in the face of sensational headlines (ie. Meredith Whitney default predictions in 2010) and idiosyncratic credit situations (Detroit & Puerto Rico 2013). The two aforementioned and fairly recent panics caused dramatic selloffs that were quickly followed by substantial rebounds. Keep in mind that the municipal market is comprised of a wide variety of credits. It is far from homogeneous. In times of high anxiety in the market, it’s best to consider the broader fundamentals and long-term benefits of municipal bond investing.

We tend to steer away from lower credit quality and long duration, as well as cash. Reaching for yield outside one’s comfort zone by adding volatile long-dated issues and/or taking excessive credit risk is not recommended, although neither is making duration bets by holding cash in anticipation of eventual higher rates. We continue to prefer investment grade quality, intermediate duration, premium coupon munis in the 7- to 12-year range. Bonds in this part of the yield curve generate decent yield without as much of the price volatility that longer bonds will face when rates eventually rise.

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