Research Note
March 2014

Municipal Bonds Find Their Footing in the New Year

We maintain our neutral positioning for municipal bonds.

- As prices fell and yields rose in the latter half of 2013, investors pulled money from muni bond funds, forcing managers to sell bonds in an increasingly illiquid market.
- Conditions reversed around year-end into 2014 as Treasury yields have fallen, money began flowing in, and issuance plummeted.
- Puerto Rico's massive post-downgrade March bond issue helped stabilize credit-spooked muni investors.
- Investors should keep an eye on yields and issuance, and of course focus on the Treasury market as well, given munis' close relationship with Treasury yields. If municipal bond yields narrow back below 2%, we would likely again call for underweighting these bonds. To convince us to move to an overweight posture, yields would have to breach 3.5% or higher, requiring a substantial sell off.

After enduring a dismal 2013 (the worst calendar year in nearly two decades),[1] municipal bond prices have rebounded sharply in the first three months of 2014. Yields of ten-year munis have fallen nearly 50 bps since year-end, for a total return of 2.8% year-to-date. While the decline in yields has been sharp, stresses remain in parts of the muni bond market, and some of the asset class's recent strength may prove evanescent. This research note reviews muni activity over the past several months, discusses reasons for the recent rally,

[1] The Barclays 10 Year Municipal Bond Index returned -2.2%, the worst return since 1994's -4.8% result. The Barclays 1-10 Year Index, a popular benchmark, posted a small loss (-0.3%), its first since 1994.

and outlines potential catalysts for the muni market in the near term. In our view, eventual returns from this starting point are likely to be more humdrum, and after advocating last July that investors go to a neutral posture (from our previous underweight view last spring), we maintain our neutral positioning.

Taper, Tradewinds, and Tax-Loss Selling Combine for a Muni Takedown in 2013

Concerns about Federal Reserve tapering and eventual tightening, combined with credit woes in Detroit and Puerto Rico, spelled trouble for municipal bonds in 2013. After touching 1.7% near the end of 2012, yields of ten-year munis hovered around 2% for the early months of 2013. This changed rather dramatically starting in May and June, when the Fed's conversation about the pace of quantitative easing moved from the confines of an FOMC boardroom, to newspaper front pages, and ultimately to the dinner tables of the families that own many of the nation's municipal bonds. Ten-year muni yields hit 3.32% on September 5, and they remained near 3% for much of the second half of the year (Figure 1).

In the muni bond landscape, falling bond prices periodically spur fund outflows and tax-loss selling in a vicious cycle, and 2013 was no exception. Investors pulled more than $50 billion in net assets from muni bond mutual funds during the year (Figure 2), forcing managers to sell bonds in an increasingly illiquid market to meet redemptions, thus driving prices lower. The net outflows continued through year-end.

Figure 1. Yields for Ten-Year Municipal Bonds and Treasuries
February 28, 2004 – March 21, 2014

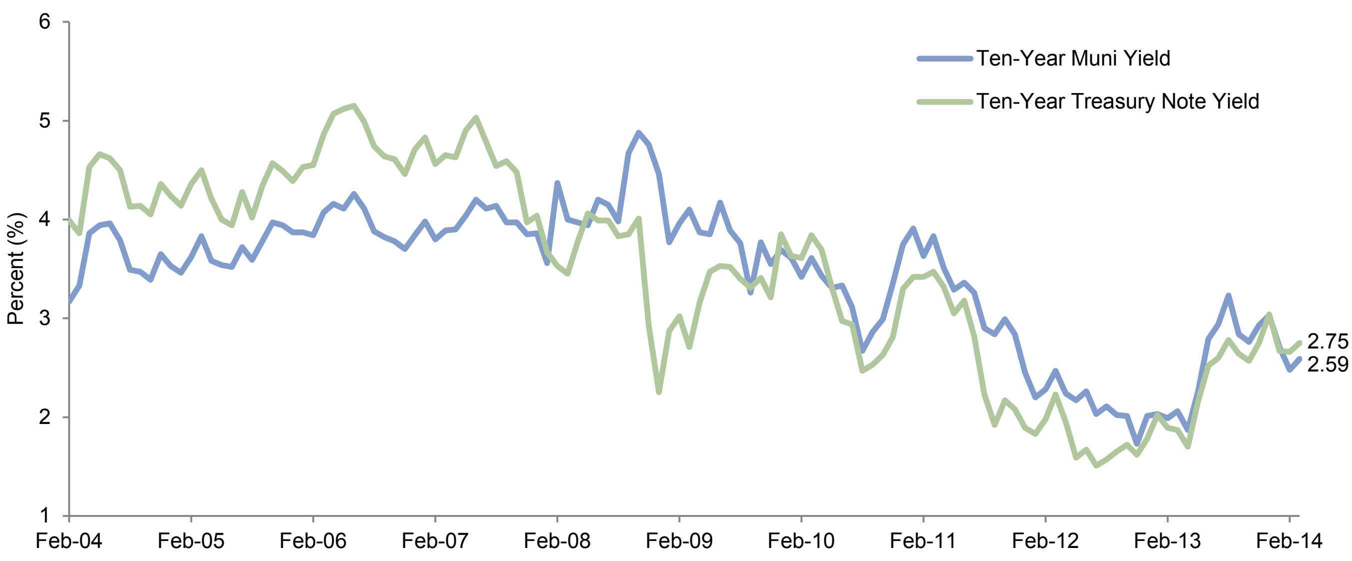
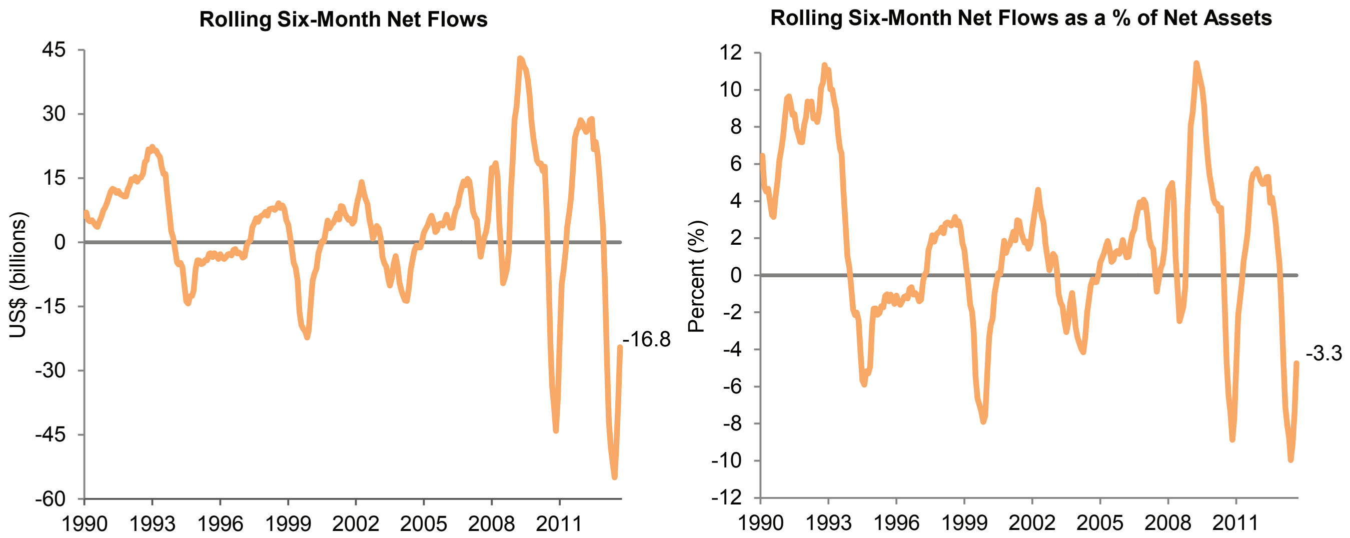


Figure 2. Net Flows into Municipal Bond Mutual Funds
March 31, 1990 – March 12, 2014



While muni investors were growing more averse to bonds in general given the Fed's changing posture, muni-specific credit concerns further raised the anxiety level. Detroit filed for bankruptcy in July, after many years of apparent financial mismanagement and a troubled local economy. The bankruptcy filing was not a big surprise to bond-market professionals (some pension bonds were trading below 40 cents on the dollar before the filing), but some municipal bondholders evidently were shaken by the significant haircuts proposed for Detroit's general-obligation bondholders. While Detroit bonds were almost nonexistent in muni mutual fund portfolios, this was not the case for another troubled credit: Puerto Rico. Because its bond income is generally exempt from federal, state, and local income tax even for bondholders that live in other parts of the United States, the tropical commonwealth's lavish spread of bonds ($70 billion outstanding) has been popular fare for retail mutual funds, particularly single-state funds.[2] While members of the muni bond community had raised concerns in recent years about Puerto Rico's massive debt load, poor fiscal health, and troubled economy (indeed, we highlighted it as a risk in our December 2012

[2] Take for example a fund that aims to provide income that is tax-free for residents of Maryland. The supply of Maryland bond issuance is not particularly diverse (and yields generally are on the low side), so fund managers have often added a slug of Puerto Rican bonds to the mix for single-state funds. Morningstar reported last year that Puerto Rican bonds could be found in 70% of municipal bond mutual funds. Wealthy Puerto Rican investors were another concentrated holder of the bonds: UBS managed a popular range of leveraged closed-end funds that were stuffed full of local bonds and marketed to the island's high-net-worth investors.

edition of *Notes on Current Valuation*), many investors paid little notice until a well-researched August article in *Barron's* spelled out the issues to the magazine's hundreds of thousands of readers. Puerto Rican bonds had long traded at a moderate yield spread above higher-quality muni bonds (and at that point they had been tottering just above the investment-grade ratings threshold for several months), but as mutual fund managers worked to reduce their Puerto Rican holdings by selling them into an already illiquid and overstuffed market, yields skyrocketed (Figure 3). Ten-year general obligation bonds that had been yielding 5% in April topped 10% in October, grabbing headlines in investment publications and likely spurring further mutual fund redemptions.

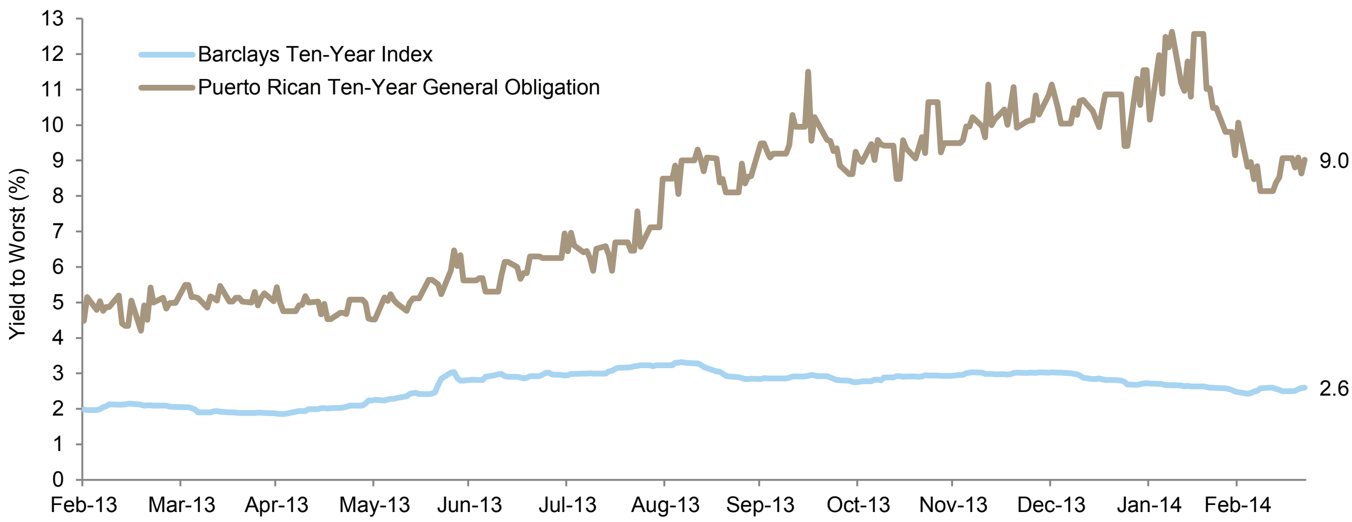
What Stopped the Pain?

But eventually, the muni-bond selling slowed and the price pressure arrested. What caused conditions to reverse course around year-end? We believe it is the result of several factors.

First, muni bonds *are* bonds, and yields of ten-year Treasuries have fallen 27 bps during the first three months of the year, as investors worried about turmoil across Turkey, Thailand, and Ukraine, and debated the role of poor weather in the recent softness of US economic data. When Treasuries rally, muni bonds tend to follow suit (although sometimes to a greater or lesser degree than Treasuries).

Second, the long, dismal stretch of bond-fund net outflows that persisted *for 32 consecutive weeks* finally abated as 2013 came to a close. Investors

Figure 3. Yields of Barclays Ten-Year Municipal Index and Selected Puerto Rican Ten-Year General Obligation Bonds
February 28, 2013 – March 21, 2014



can sell to lock in a tax loss at any point in the year, but in reality, most tax-motivated selling appears to be concentrated in the third and especially the fourth quarters of most years. Inflows in January and February 2014 were not particularly robust, but they were at least in the positive direction.

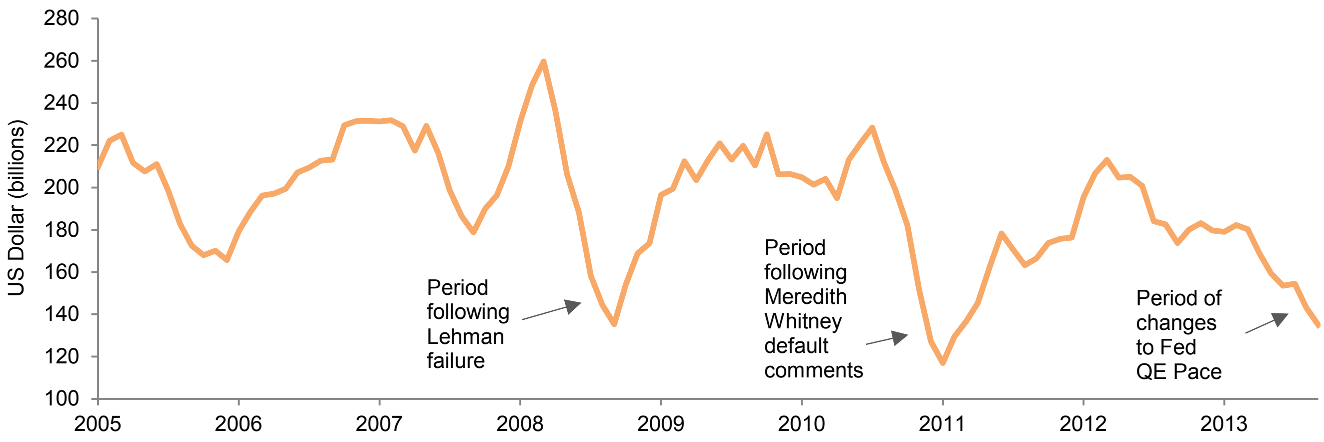
Third, muni bond issuance has plummeted recently, and this supports the prices of existing bonds (portfolio managers that wish to remain fully invested have to buy *something* when their holdings mature or pay coupons). February's issuance total of less than $15 billion was the second-lowest monthly value of the last nine years, and issuance over the past six months was well below typical recent levels (Figure 4).

A potential fourth factor in the 2014 rally is quite counter-intuitive. Starting in early February, Standard & Poor's, Moody's, and Fitch downgraded many of the largest bond-issuing agencies in Puerto Rico to below investment grade, causing bond prices to … *rally*. With the feared downgrade sword no longer hanging over the island's head, the commonwealth's new bond-friendly administration has talked up plans to eliminate the budget deficit by 2015 and in mid-March issued the island's first new general obligation bond in two years. The mammoth $3.5 billion bond issue was a blockbuster, with $16 billion in orders from hedge funds and other investors hungry for the 2035 bond's 8.7% tax-free yield.[3] The prices of some existing general obligation ten-year bonds have risen by more than 10% from early February (before the downgrades) to mid-March as yields have plummeted (they remain quite elevated).

[3] The island's Government Development Bank said that the bond issue would provide Puerto Rico with adequate liquidity for approximately 16 months, provided the island runs a balanced budget in 2015 (which would likely require substantial further cost-cutting). Disclosure: as of the publication of this report, the author owned municipal bonds issued by certain Puerto Rican government agencies and public utilities.

Figure 4. Rolling Six-Month Issuance of Municipal Bonds

June 30, 2005 – February 28, 2014



What to Watch

For municipal investors, or those considering the bonds, the rapid turnabout and strong technicals may make some bond buyers more comfortable, while the recent dip in yields may give pause to value investors. While the wind is at the backs of bond owners today, following are some potential catalysts to keep an eye on:

- **Sharp further yield compression could be a yellow card for value-oriented buyers.** In early March, we moved our valuation assessment for municipal bonds to *overvalued*, after eight months in fair value territory. The sharp compression in yields has lowered the long-term return expectation for the asset class (initial yields are an excellent predictor of subsequent long-term returns). That said, we don't believe that the modest level of overvaluation today (Figure 5) should push investors to sell muni bonds and raise cash, as we advocated a year ago amid ten-year yields of around 2%. But *if yields narrow from today's 2.6% level to perhaps 2%, we would likely again suggest an underweight posture.*
- **Today's lower yields could prompt a rebound in issuance.** Investors that are counting on a continued tailwind from the meager pace of recent muni bond issuance may be surprised: in early 2011, elevated yields turned off the issuance spigot, but after a 54 bp yield decrease in April and May 2011 (similar to the year-to-date 2014 decline) issuance picked up, with June 2011 seeing a chunky $32 billion in supply. *Yield stabilization or contraction may release pent-up issuance, limiting demand for existing bonds.*

Figure 5. Municipal Bond Valuations
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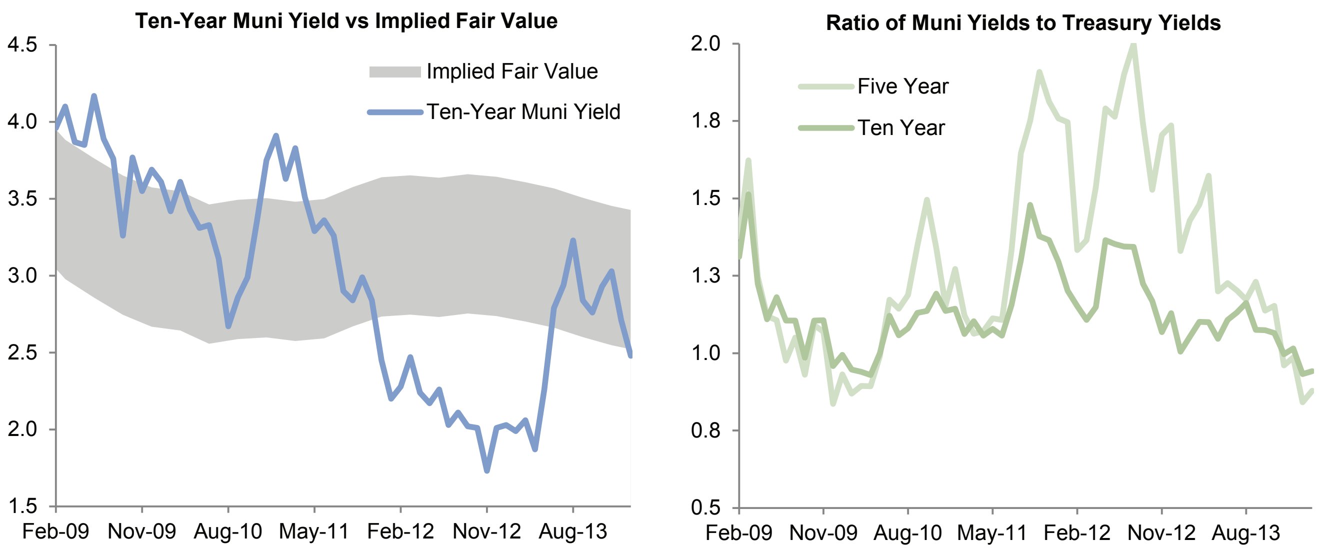

- **Near-term track of Treasury yields is a toss-up.** Of course, Treasury yield changes will also impact munis over the near term, but we have few insights into their short-run course. Currently the Treasury market is roughly balanced, with bond support coming from Ukraine-related concerns and soft US economic data, while investors nervously eye the pace of quantitative easing and future rate hikes under new Fed Chair Janet Yellen. Inflation remains quite low and stable, and deficits are gradually shrinking. It is impossible to know in which direction today's balanced Treasury market will tip. If Treasury yields rise, muni yields are likely to pace them, while falling Treasury yields would likely be bullish for munis.[4]

Long-Term Risks Remain in the Background

Even though technicals have improved, longer-term risks to the asset class remain. These include pension plans that in some cases are woefully underfunded (and in many cases *would be considered* underfunded if more conservative return projections were used),[5] and the potential for legislative attacks on the tax advantages that municipal bonds provide to their holders.[6] Pension underfunding remains a concern, but we believe that heightened taxpayer/voter awareness of the problems will encourage a continued legislative focus on reforms and shared sacrifice. As to the prospect of legislation undermining the tax benefits to muni bond holders, we believe substantial changes are unlikely given that issuers would present a united front against aggressive legislation.

Conclusion

The best times to buy muni bonds tend to be when the world seems to be moving against them: late 2008 during the credit crisis as levered portfolios were being unwound, early 2011 amid the Meredith Whitney–induced sell-off, and perhaps last summer as Fed panic was heating up. This is no longer one of those times of high risk and long-term reward from providing liquidity to panicked sellers. Eventual returns from this starting point are likely to be more humdrum. That said, last July we advised investors to move back to a neutral posture toward muni bonds (from an underweight posture earlier), and we see no compelling reason today to deviate from that neutral posture. Assuming no material change in the economic environment, any near-term move to yields back below 2% would likely again spur us to advocate an underweight posture towards muni bonds. Moving to an overweight posture, on the other hand, would likely require a substantial sell-off, with yields breaching 3.5% or higher. ■

[4] The exception to this would be a fall in yields due to some sort of liquidity or other crisis, during which muni bonds would likely underperform Treasuries.

[5] For more on pension liabilities, please see our March 2011 Market Commentary *Long Muni Bonds: Unloved, Orphaned, and Perhaps Safer than You Think*.

[6] For example, the tax reform proposal floated last month by House Ways and Means Committee Chair Dave Camp would tax wealthy muni bond holders. The proposal does not appear to be getting traction, yet bondholders remain somewhat vulnerable in the current, strained fiscal environment, given the federal revenue lost to the municipal bond tax exemption each year. This vulnerability is balanced to a degree by the pressures that state and local borrowers might place on Congress if they feared tax reforms would raise their cost of borrowing.

Contributors

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Exhibit Notes

Yields for Ten-Year Municipal Bonds and Treasuries Chart
Sources: Barclays and Thomson Reuters Datastream.
Note: Data are monthly except the end point, which is as of March 21, 2014.

Net Flows into Municipal Bond Mutual Funds Chart
Sources: Investment Company Institute and Thomson Reuters Datastream.
Notes: The denominator of the flows as a percentage of net assets calculation is the asset level at the beginning of the six-month measurement period. Data for February and March 2014 have been estimated using weekly flows from the Investment Company Institute.

Yields of Barclays Ten-Year Municipal Index and Selected Puerto Rican Ten-Year General Obligation Bonds Chart
Sources: Barclays and Electronic Market Access®.
Note: Puerto Rican bond yields reflect an average for three bonds that mature in 2023–35, based on trades within EMMA database.

Rolling Six-Month Issuance of Municipal Bonds Chart
Source: Thomson Reuters Datastream.

Municipal Bond Valuations Chart
Sources: Barclays and Thomson Reuters Datastream.
Note: Implied fair value based on Barclays Municipal Bond Index yield history relative to the tax-adjusted rolling ten-year average US GDP growth.