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Municipal Bonds: Incredibly Low Yields, But Few Attractive Alternatives

We maintain our neutral positioning for municipal bonds

- Though yields have moved below the 2% level that we previously viewed as a threshold for underweighting munis, other factors have changed the equation.
- Treasury yields have plunged as well, and ten-year Treasuries currently yield less than ten-year munis. Muni issuance remains quiescent, with new issuance at its lowest level since 1997.
- A multitude of factors could negatively impact munis, including a deflationary downturn that shrinks state and local revenues; still, the tax advantages of munis are significant and munis compare favorably to Treasuries and corporate bonds on a tax-adjusted basis.

A little less than a year ago[1] we expressed an equivocal opinion on US municipal bonds—while we considered them overvalued, we also recognized that munis were supported by technical factors such as low issuance, strong fund flows, and low Treasury yields. As it happens we were too cautious; munis have returned 7.4% since that point, driven by a flattening yield curve as long bonds rallied strongly in sympathy with Treasuries.

At the time, we said a ten-year muni yield under 2% would likely cause us to recommend an underweight to munis absent some change in the economic

[1] See Sean McLaughlin et al., "Municipal Bonds Find Their Footing in the New Year," Cambridge Associates Research Note, March 2014.

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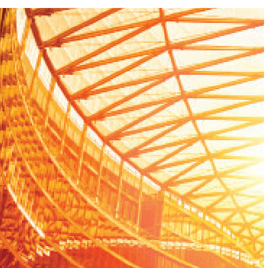


environment. The ten-year yield closed January at 1.73%, and we are forced to invoke Keynes' (possibly apocryphal) quote about changing his mind when confronted with new facts. The relentless decline in global bond yields and the recent plunge in oil prices, among other factors, have changed the equation, and a sub-2% yield no longer looks quite so bad.

Thus, we once again maintain our neutral posture on munis despite their low yields. While future returns are to some degree capped by such yields, this is offset by their *relative* attractiveness to other asset classes. Further, the technical supports cited in our research note last year remain in place, with solid fund flows and low issuance auguring well for muni prices.

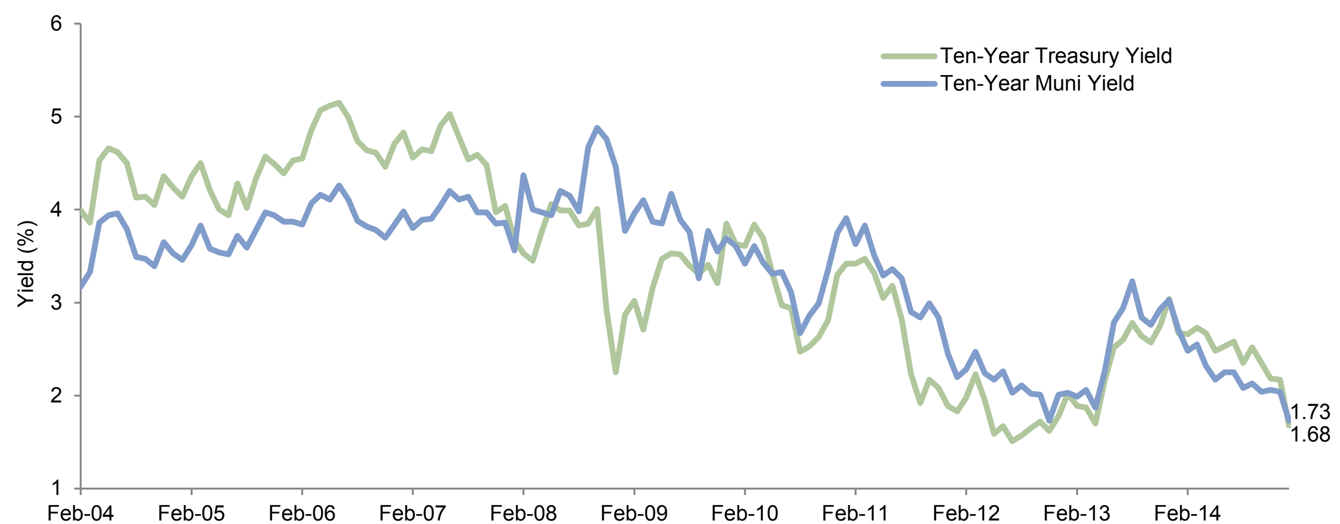
Finally, given the potential for landmines in the muni market (e.g., the 2014 plunge in Puerto Rico[2] bond prices as it became clear the island would not be able to meet commitments), we not only recommend investors use an active manager for this sector, but would also advise against the temptation to trade safety for yield.

Going … Down?

As remarkable as has been the relentless decline in muni yields, it has actually been surpassed by the plunge in Treasury yields (Figure 1). Ten-year munis are back in the historically unusual—although common post-2008—position of yielding *more* than comparable Treasuries despite

[2] While this has fallen from the headlines, the situation remains far from resolved, and could potentially trigger another market-wide swoon if, and when, things finally come to a head (i.e., a restructuring is put in place, locking in losses for investors).

Figure 1. Yields for Ten-Year Municipal Bonds and Treasuries
February 29, 2004 – January 31, 2015



their tax advantages, and five-year munis are nearly there (Figure 2). (Indeed, the addition of the Medicare surtax has pushed the maximum federal rate to 43.4%, and on a tax-adjusted basis muni yields compare favorably not only to those of Treasuries, but also to corporate yields [Figure 3].)

There are good reasons for this, of course, mostly having to do with the fact that states and municipalities cannot simply print their own currency as can the US government, as well as the fact that Treasuries draw from a far larger global pool of investors than do munis. Thus, while the vast majority of munis are likely money good, this is not true across the board as it is for Treasuries, as evidenced by the recent bankruptcies of Stockton, California, and Detroit, Michigan. There is also likely a floor for muni yields that does not exist for Treasuries; while Treasuries could still make sense at extremely low yields in a deflationary environment, the same cannot be said of munis, where the ability to make payments would likely be compromised by falling tax collections.

Technically Speaking

Somewhat surprisingly, the drop in yields has yet to spark a surge in issuance. In fact, 2014 issuance was not only weak—issuance was virtually the same as in 2013, and lower than nine of the 11 prior years—but the volume of new issues (as opposed to refundings) was the lowest since 1997 (Figure 4). Issuance did spike in January 2015—to $29 billion, the biggest January in five years—but 68% was used to refund existing issues.

Figure 2. Ratio of Muni Yields to Treasury Yields
January 31, 1988 – January 31, 2015

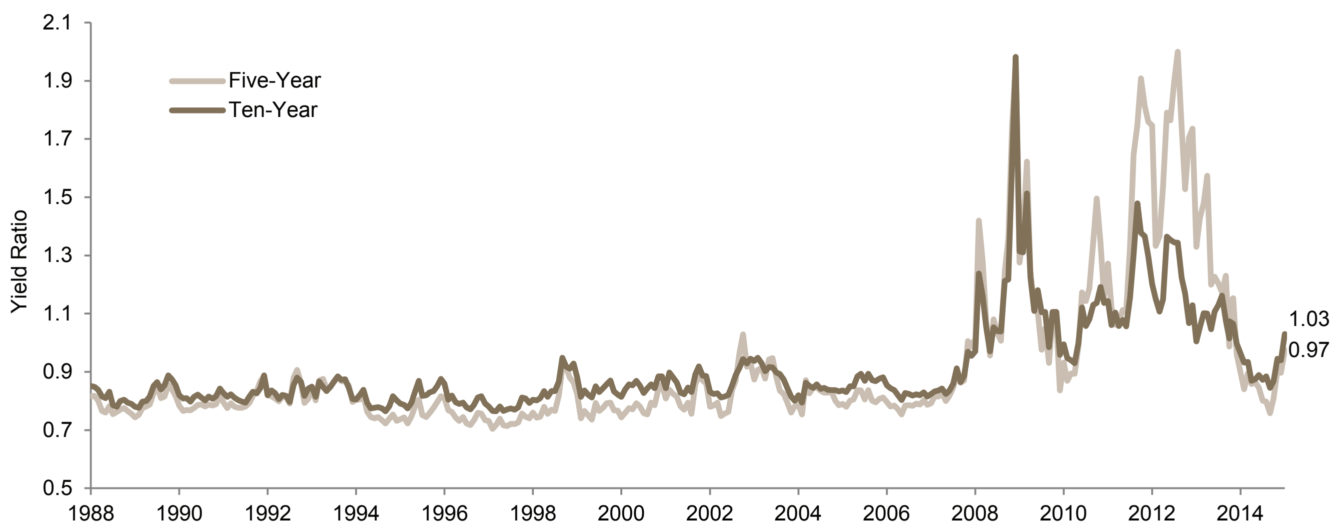


Figure 3. Tax-Adjusted Yields
As of January 31, 2015

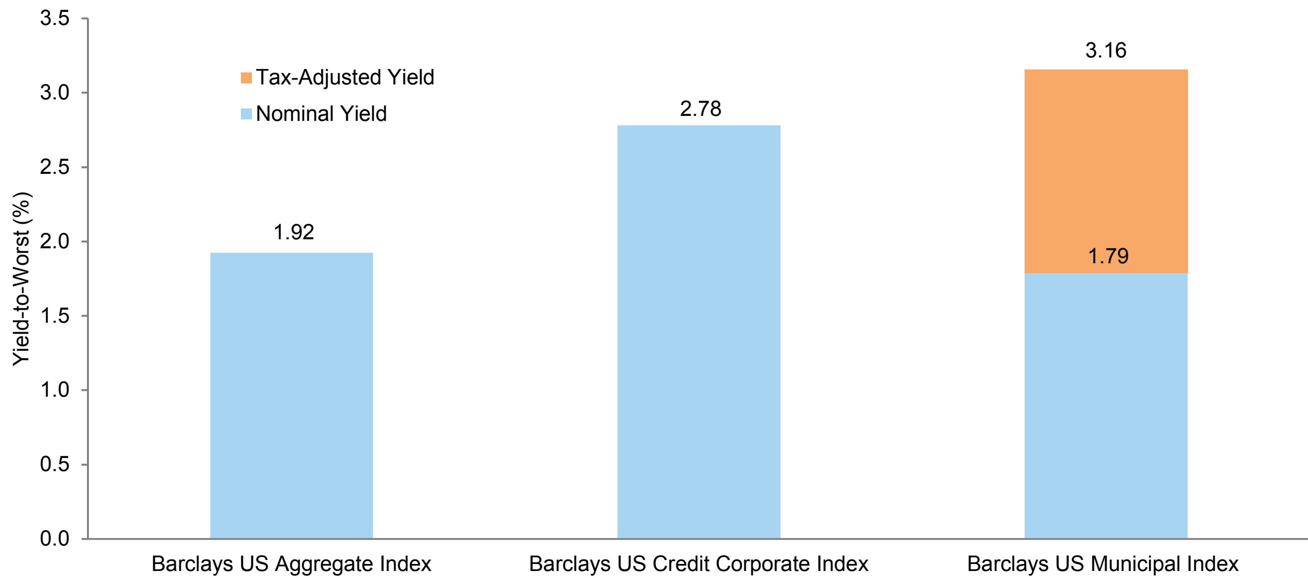
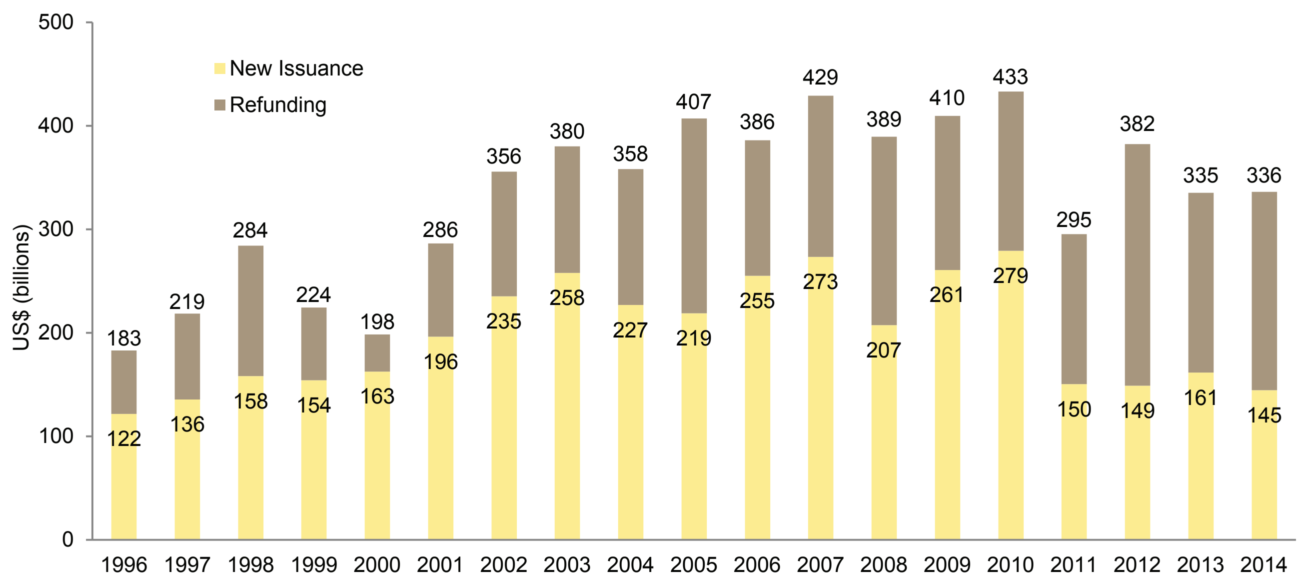
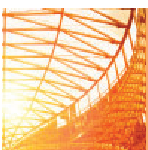


Figure 4. New vs Refunding Municipal Bond Issuance
1996–2014





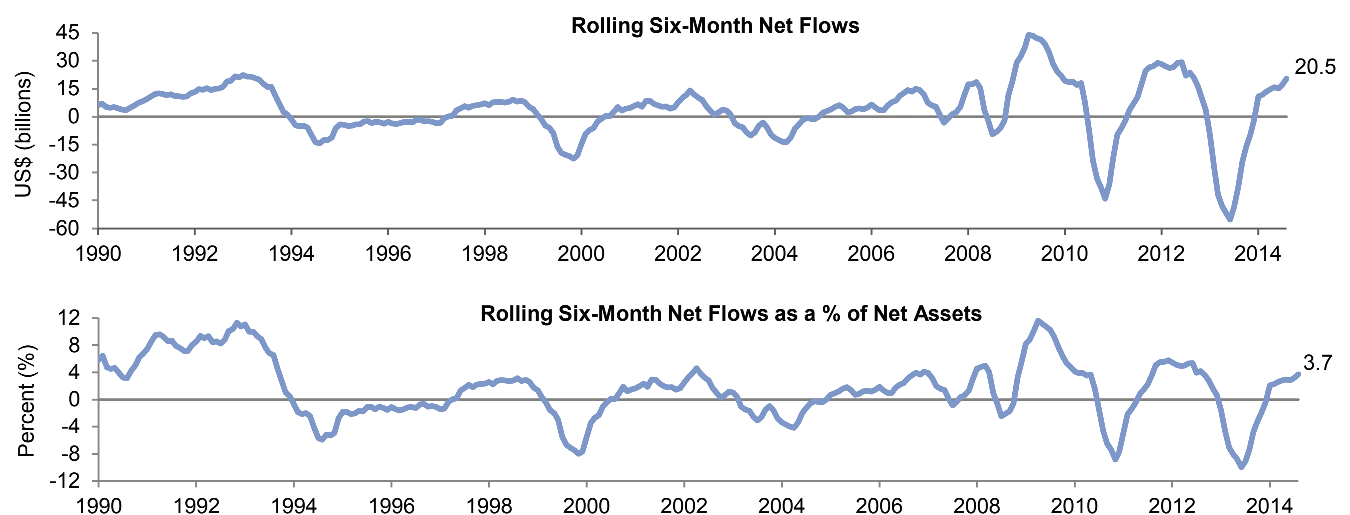
Fund flows, meanwhile, have rebounded as prices have risen … or is it the other way around (Figure 5)? Either way, investors are clearly comfortable putting cash to work in munis, at least for the moment, despite low yields. While flows are, of course, fickle, the absence of new supply, coupled with the seemingly endless volume of capital seeking investment options in a world of expensive assets, makes a *sustained* rise in yields unlikely absent some fundamental change in the economic environment.

What About Those Pension Issues?

No analysis of munis is complete without touching on this topic, which has gotten an increasing amount of press of late. In short, many states and municipalities have promised more in pension/health benefits than they can possibly afford to pay, raising the prospect of what some have termed a "death spiral" as rising taxes necessitated by constitutionally protected benefits erode the tax base by driving out residents, thus forcing taxes higher, in a vicious circle.

This gap in what has been promised and what can be paid is a legitimate issue, and investors should certainly be aware of it. However, from an investment standpoint it is possible to mitigate. Further bankruptcies do seem likely in certain states—e.g., California and Illinois—but even in such places many bonds will be paid in full; the muni market is certainly large enough for managers to fill out portfolios while avoiding troublesome issues … assuming they avoid the temptation to reach for yield! As noted earlier, we recommend investors use active managers and tilt toward safe issues as opposed to reaching for yield. Some investors may also benefit from using a separate account, where the

Figure 5. Net Flows into Municipal Bond Mutual Funds
January 31, 1990 – January 31, 2015



manager can be given specific instructions to follow these guidelines, although such accounts typically also come with higher fees and can be difficult (and expensive) to liquidate.

Recent events also suggest there may be cause for optimism. The recent bipartisan wave of reform-minded governors elected in troubled states—e.g., Republicans Scott Walker of Wisconsin and Bruce Rauner of Illinois, and Democrat Gina Raimondo of Rhode Island—suggests voters are waking up to this issue. We would still advise investors to steer clear of states with serious pension underfunding, as any "solutions" will likely include haircuts for bondholders, but this is nothing more than prudent active management.

What Could Change Our View?

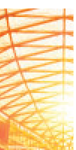
We have painted a rosy picture of an asset class with record-low yields, or, said another way, record-high prices. And it certainly appears that current muni yields leave little room for error. A number of factors could negatively impact munis, making a neutral posture the wrong one to hold. These include, but are not limited to, the following:

1. Inflation rears its head and pushes yields higher.
2. Economic growth accelerates, dragging yields with it.
3. Pension issues are worse than anticipated, and bite earlier than expected.
4. A deflationary downturn takes hold, shrinking state and local revenues.
5. Investor appetite for munis declines.

There is a fair amount of overlap here, and clearly any combination of these could spell trouble for munis. Should any of the above scenarios begin to play out—absent a commensurate rise in yields—we would likely shift to an underweight posture. Conversely, given the muni market's historical tendency to overreact to perceived bad news—e.g., the sell-off sparked by Meredith Whitney's December 2010 comments that muni bankruptcies would be in the "hundreds of billions"—any rise in yields spurred by a high-profile default or some other "newsworthy" event would likely (again, *ceteris paribus*) cause us to become more constructive. In sum, we feel comfortable owning municipal bonds at current yields—with the aforementioned structural safeguards in place—but they clearly bear close watching.

Conclusion

It is difficult to get excited about an asset class that yields less than 2%, no matter how safe it seems, and eventual returns from this starting point are likely to be low. Nonetheless, we find ourselves continuing to hold a neutral view on munis, even as yields plumb lows that would have seemed ridiculous a few short years ago. With Treasury yields at remarkably low levels as well, reasonable issuance for munis, and their significant tax advantages, taxable investors should maintain allocations to the asset class. ■



Contributors

Eric Winig, Managing Director
TJ Scavone, Investment Associate

Exhibit Notes

Yields for Ten-Year Municipal Bonds and Treasuries
Sources: Barclays and Thomson Reuters Datastream.

Ratio of Muni Yields to Treasury Yields
Sources: Barclays and Thomson Reuters Datastream.

Tax-Adjusted Yields
Source: Barclays.
Note: The tax-adjusted yield takes into account the tax benefits for the highest tax bracket at the new maximum rate of 43.4%, which includes the Medicare surtax.

New vs Refunding Municipal Bond Issuance
Source: Sifma.

Net Flows into Municipal Bond Mutual Funds
Sources: Investment Company Institute and Thomson 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 January 2015 have been estimated using weekly flows from the Investment Company Institute.

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