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Munis Face Challenges In 'Choppy' 2014 - Barclays.

After a lousy 2013 for muni bonds, Barclays sees better times ahead next year – perhaps. From Barclays muni strategists Thomas Weyl, Sarah Xue and Ming Zhang:

While we expect munis to outperform Treasuries, a lot of challenges remain, and the municipal market could be choppy in the next year. A lot will depend on fund flows and the supply/redemptions dynamic. The latter should be supportive, but a strong rally is not likely without a stabilization of fund flows. We think that it will be difficult for fund flows to stabilize until the Fed starts to taper. The muni market could react adversely in the early stages, but we think that outflows will reverse – similar to the 2005 experience – as valuations likely become attractive and the benefit of tax exemptions increases with rising rates.

Similar to 2013, Barclays sees headline risk in 2014 that could come from Puerto Rico and Illinois, as well as from underfunded pension and benefit plans across the muni market. Otherwise Barclays says “overall municipal credit quality is actually improving due to modestly increasing revenues” while “the largest issue regarding municipal credit quality will be the increasing payments required to meet retiree obligations: pensions and health care.”

Among tax-exempt bonds, Barclays sees value in long bonds, given the underperformance of longer-duration municipal bonds and a steep muni curve. From Barclays:

We expect the muni curve to flatten next year, in line with expectations in the Treasuries market. We also think that the A-rated portion of the index looks attractive at current levels given its underperformance this year, as well as improving municipal credit quality. On a sector basis, we believe the following sectors offer relative value: hospital, IDR/PCR, transportation, and water and sewer. Finally, muni HY looks attractive versus US HY, with the ratio of the former to the latter at 119%, an all-time high.

On the taxable side, Barclays says it sees value in intermediate taxable munis and the power sector within long taxables.