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The Irrational Fear of Muni Bond Defaults.

All the negative news has created a massive buying opportunity

This year has been full of an exhausting parade of headlines related to defaults and potential defaults in the municipal market. While some of these headlines are warranted because of the size of the default, very few municipal bond managers were surprised by Detroit or the problems Puerto Rico is having.

The bigger surprise came as credit spreads widened to levels typically associated with defaulted bonds for an issuer that is still investment grade. Add a few smaller issuers that defaulted to the headlines and it may seem that Meredith Whitney's prediction has come to fruition. While her prediction is far from accurate, in our opinion, the fear mongering has played an important part in creating an environment of irrational fear among investors.

A deeper look into the history of defaults reveals some very surprising facts that are overlooked when investors are worried about which one of their holdings is going to default next out of the thousands of issuers in the municipal market. According to the most recent study of defaults done by Bank of America, year-to-date defaults through Nov. 26 are at $2.47 billion versus $3.81 billion for all of 2012.

According to those numbers, the municipal market would need a 54% increase in its current total in the last month of the year just to match last year's defaults. Add on top of that fact that $2.47 billion is only 0.08% of the $3 trillion municipal market. Break the numbers down a little and only include investment grade securities, according to a study done by BNY Mellon, the worst default rate they could for find is 0.30% and that is for BBB bonds after 10 years. Compare this default rate to similarly rated corporate bonds over the same timeframe at 4.74% and the fear seems unjustified.

This irrational fear has had investors running to the exits for most of the year as the market is witnessing historic outflows. The outflows have caused forced liquidations by managers at levels they might not have sold bonds at, which has led to municipal bonds trading at significantly cheaper levels relative to all other taxable fixed income asset classes. Municipal bonds have historically traded at 85% of U.S. Treasuries, due to the fear generated by the overabundance of headlines they have fluctuated at 100% of Treasuries.

When the numbers are looked at rationally and investors realize the risk associated with the municipal market, they will realize that all this negative news has created a massive buying opportunity, whether they believe rates are headed higher or not. The relative cheapness of municipals and the steepness of the yield curve can provide a cushion if rates do rise in the future. One thing to keep in mind is that the municipal market is not an easy place to navigate and a professional money manager is imperative in structuring a portfolio that will take full advantage of the cheapness of the market, and to monitor the credit of the portfolio in order to avoid the risks that do exist.

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Dec 24, 2013 @ 12:01 am (Updated 3:30 pm) EST