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After Two Years as a Fixed Income Star, Munis Lose Luster in First Quarter.

NEW YORK — U.S. municipal bonds drew investors and yielded positive returns throughout the first quarter of this year, but their performance paled compared to Treasuries, which gained in January during a Chinese-led global stock market rout.

The Treasury rally marred a two-year run of outperformance by municipal bonds. Both asset classes were later cut down after recovering oil prices contributed to a broader risk-on sentiment.

Munis returned 1.67 percent as of March 31, according to Barclay's Municipal Bond index, versus 3.20 percent for Treasuries.

BlackRock called February "a long, strange month" for debt issued by states, cities and other local governments, because strong momentum after eight months of positive runs finally met resistance.

In 2015, munis returned 3.30 percent versus 0.84 percent for Treasuries. Munis returned 9.05 percent in 2014 versus 5.05 percent for Treasuries.

With munis currently underperforming Treasuries, "long-term tax-exempt yields are now higher than the taxable alternatives pre-tax, a fact that should attract more demand from crossover buyers," BlackRock directors said in a March commentary.

Banks predicted late last year that 2016's muni performance will underwhelm.

Bank of America Merrill Lynch projected full 2016 total muni returns will be 3.10 percent, while Morgan Stanley estimated 1.25 percent and Barclays a negative 1.00 percent.

Not everyone thinks munis look dull.

"I really don't see that as true at all," said Stephen Winterstein, chief municipal fixed income strategist at Wilmington Trust. "In the first quarter we've achieved over one-third of the performance of 2015… Never annualize."

Volatile equity markets have driven stability-seeking investors to munis, Winterstein said.

"It wasn't that munis did real poorly," said Dan Heckman, senior fixed income strategist at U.S. Bank Wealth Management. "They just kind of took a little step back."

Investors sank $12.5 billion into muni bond funds in the first quarter, the most since a net inflow of $14.5 billion in the third quarter of 2012. Flows have been positive for 26 consecutive weeks, according to data from Lipper, a Thomson Reuters company.

To be sure, trouble spots linger in Illinois and elsewhere.

PNC Capital Markets found 79 percent of mostly buy-side analysts in a recent survey have a "lower"

or “much lower” level of trust toward states’ and cities’ willingness to honor bondholder obligations now versus five years ago.

Yet despite concerns, including continuing crises in Puerto Rico and public pension underfunding, “the municipal market is still regarded as a very high quality market,” Winterstein said.

In many cases, primary deals have not had enough bonds to satisfy investor appetite.

For example, in a March 14 deal from the California Health Facilities Financing Authority for the Lucile Packard Children’s Hospital, term bonds maturing in 2055 were 11 times oversubscribed, Winterstein said.

NEW MONEY

Though demand is high, supply remains low, a technical aspect boosting the $3.7 trillion muni bond market.

Overall muni issuance fell 7.5 percent to $96.2 billion in the first quarter compared to the same quarter last year. New money bonds rose 37 percent year-over-year to nearly $38 billion while issuance tied to refunding dropped 23.4 percent to $58.5 billion.

That is a shift from last year when refundings dominated, but the change could be short-lived.

“We would anticipate that refunding issuance will increase given the rate outlook and low nominal rates going forward,” said James Grabovac, a strategist at McDonnell Investment Management.

The slight underperformance could entice more investment dollars into munis.

“Valuations are relatively attractive, especially as you move 10 years and beyond,” Grabovac said.

Citigroup was the top underwriter for the quarter, and California sold $2.95 billion of debt, more debt than any other issuer.

By REUTERS

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(Reporting by Hilary Russ and Chizu Nomiyama)

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