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Q1 2019 Review: Tax-Free Municipal Bond - A Shining First Quarter For Munis

Summary

- Muni supply is down. The drop last year has carried over to this year.
- Demand is also higher, particularly in the high-tax states like New York, New Jersey, and California.
- In the past few weeks, longer-maturity munis have also declined in yield as investors have moved further out on the yield curve to secure incremental yield.
- Clearly, there has been a reversal in bond market sentiment since last October, when the 10-year Treasury reached nearly 3.25%.

The first quarter of 2019 was a good one for the tax-free bond market, with yields falling during the quarter.

There are two main reasons that munis have had a good run so far this year.

Muni supply is down. The drop last year has carried over to this year. Remember, 2018 supply was down almost 25% compared to 2017 supply, in part due to the glut that was issued at year-end 2017 to beat the tax bill. The market has struggled with lower supply since. A great deal of the drop in supply can be traced to the 2017 tax reform act, which prohibited advance refundings of older, higher-coupon municipal bonds. Refundings were an important source of supply in past years, particularly in 2014 and 2016.

Demand is also higher, particularly in the high-tax states like New York, New Jersey, and California. Because of the SALT provisions of the tax bill, the cost (in terms of foregone yield) of owning out-o--state bonds in these states is much higher. We don't see this demand factor changing. (See our February piece regarding the SALT conundrum.)

In the past few weeks, longer-maturity munis have also declined in yield as investors have moved further out on the yield curve to secure incremental yield. Also, the more dovish stance by the Federal Reserve since year end, reinforced in the March Federal Reserve meeting, has seemed to ease retail investors' normal reluctance to invest in longer maturities. The tax-free muni yield curve is also much steeper than the Treasury yield curve is, with the difference between 10- and 30-year AAA munis at approximately 80 basis points, while the difference between 10- and 30-year Treasuries is only 44 basis points.

What does all this positive movement in the muni market mean?

Clearly, there has been a reversal in bond market sentiment since last October, when the 10-year Treasury reached nearly 3.25%. The 10-year is back to a 2.45 yield, but the drop of 80 basis points has been accompanied by almost no drop in the rate of core inflation (nor any rise). And even though headline inflation has fallen (mainly due to oil), the drop in real yields has caused us to reassess bond markets in general and tax-free bonds in particular.

We think the SALT provisions are resulting in people – particularly in high-tax states – paying more this year in income taxes. In a market that has seen a resumption of bond fund inflows, we are concerned that the approaching tax deadline may see some bond selling, either directly or in bond fund form, to pay for the taxes.

We are also concerned that state and local governments – again, particularly those in high-tax states – will be under pressure from their citizens to cut taxes to make up for the extra taxes being borne because of the SALT provisions. If high-tax states oblige but don't cut expenses, debt service coverage could suffer.

Last fall, we thought real rates were high, bond selling was overdone, and the muni yield of 4%-plus was a giveaway. That yield bogey is very hard to find in a bond market that has done an about-face in the past four months. Thus, we are getting more defensive at the margin to make sure we are positioned to take advantage of any volatility accompanying April 15th. When it gets crowded at our end of the boat, we generally start moving to the other end.

Seeking Alpha

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