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Are Municipal Bonds Cheap Relative To Taxable Counterparts?

Municipals bonds have underperformed in 2013

Municipal bonds have underperformed this year after outperformance last year left absolute market yields at record lows on the Municipal Market Data (MMD) yield curve. The generic “AAA” General Obligation bond with a 30 year term was yielding 2.47% as of 11/30/12 and a year later is yielding 4.10%. Given that bond prices decline when yields increase, the municipal market is down 2.87% year to date as of November 30, 2013 after growing 6.4% in 2012 as measured by the S&P National AMT Free Municipal Bond Index. Persistent redemptions from municipal bond funds may work against municipals’ future positive performance. According to Lipper FMI, as of November 27, there were 27 consecutive weeks of net outflows from U.S. municipal bond funds, totaling $34.8 billion or about $1.3 billion per week.

Municipals present relative value compared to taxable bonds

According to Dorian Jamison, municipal analyst at Wells Fargo Advisors, municipal market yields continue to be historically cheap compared with taxable alternatives. Yield ratios between municipal bonds and their taxable counterparts continue to exceed historical averages, which indicates that municipals are still attractively priced, historically speaking.

The current MMD 10 year triple A muni to Treasury yield ratio of 96.7% remains higher than its 10 year average of 91.7%, which indicates attractive value in the municipal market. Such value tends to attract demand from non-traditional municipal bond buyers and can support municipal bond prices. When yield ratios between municipals and Treasuries fall below historical averages, they indicate that the municipal market is expensive relative to the taxable market.

Municipal to corporate bond yield ratios are even more attractive, particularly at higher tax brackets that have increased this year. For example, for an individual in the 39.6% marginal federal tax bracket, the taxable equivalent yield of a 30 year A+ rated general obligation bond is 8.9% (Source: Bloomberg), which results in a muni to corporate yield ratio of 182%. Investors that expect higher tax brackets next year should consider swapping taxable bonds with municipal bonds to get to keep more of the interest paid.

Intermediate maturities and healthcare municipal bonds

According to both Dorian Jamison from Wells Fargo & Co (NYSE:WFC) and George Friedlander from Citi, the intermediate area of the yield curve provides both value and potential for price stability in the next 12 months. Friedlander and his team highlight that the 5-7 year sector remains the most attractive. Jamison notes that interest rates could continue to rise given potential for the Federal Reserve to scale back bond purchases next year and increasing uncertainty over tax reform impact on municipals’ tax exemption.

Within the high quality municipal market, Friedlander thinks that not for profit hospitals face significant headwinds due to the ongoing implementation of the Affordable Care Act (ACA). There is still uncertainty over how the costs of care for the uninsured will be covered, particularly if states choose not to expand Medicaid. Also, not-for-profit hospitals are facing uncertainty over their tax exempt status as their community benefit, which consists of devoting at least 3% of operating revenue to care for patients unable to pay, may decline as more people get insured with the ACA.

In turn, some hospitals' tax exempt status may be threatened if not-for-profit hospitals' community benefit is not high enough. Despite these circumstances, Friedlander notes that prices of hospital municipal bonds rated A and above are attractive relative to similarly rated General Obligation and Essential Service Revenue bonds. Citi Research analysts recommend considering high quality multi state healthcare system bonds for portfolio diversification and higher risk adjusted yields. Multi state healthcare bonds are better positioned to weather challenges as their revenue base is larger and more diverse.

by Ann Marie

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