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Dealer Squeeze Could Be Muni Market's Weakest Link.

Battered by rising interest rates and credit concerns over Detroit and Puerto Rico in 2013, the muni market may face additional obstacles next year as regulatory limits on broker dealers could crimp liquidity.

Such regulations as those stemming from the Dodd-Frank Act and the Basel Accords could discourage broker-dealers at banks from participating in the buying and selling of munis, bond investors and analysts said.

Less broker-dealer participation in the marketplace could limit the market's ability to steady itself during periods of selling pressure, said Priscilla Hancock, managing director, municipal strategist at JPMorgan Asset Management.

"The biggest restriction we're going to see impact liquidity is not so much individual buyers, because it still appears to us that banks and insurance companies may buy munis," she said. "The bigger issue is broker-dealers, who traditionally provide liquidity when there are outflows."

Matt Fabian, managing director at Municipal Market Advisors, agreed. Major rule changes that restructure many of the ways the muni market does business will ramp up regulatory uncertainty and change the status quo, he said. Although it's unclear exactly how these, including the Securities and Exchange Commission's municipal advisor rules and the Municipal Securities Rulemaking Board's plans to propose best-execution rules, will play out in the marketplace.

Dodd-Frank required municipal advisors to be registered with the Securities and Exchange Commission and to become subject to Municipal Securities Rulemaking Board rules.

The MSRB is expected to propose a best-execution rule similar to that of the Financial Industry Regulatory Authority, which would require dealers to use "reasonable diligence" to determine the best venue for trading a security and to trade it so the resulting price to the customer is as favorable as possible given prevailing market conditions.

"It's regulators taking control of the muni market with the momentum from Dodd-Frank and other post-crisis initiatives, like Basel III," Fabian said. "It's going to be harder for dealers to continue to commit capital in our sector. Profits are down, uncertainty is higher, and it becomes more difficult to keep dealers committed to the market. So, if we can get through 2014 with the same number of market participants as we have now, it'll be a victory."

Basel III, approved by U.S. regulators in July with staggered effective dates through March 2018, includes standards for how much capital banks have to hold against investments in specific financial products.

The Federal Reserve Flow of Funds report for the third quarter shows that the muni holdings of brokers and dealers have been shrinking since 2010, to \$18.3 billion from \$40 billion. In addition, the muni market itself has shrunk to \$3.69 trillion in bonds outstanding, from \$3.72 trillion one

quarter earlier.

Traditionally, broker-dealers would step in and buy when muni bond funds sell, Hancock said. They've provided liquidity and facilitated customer transactions by making markets through risking their own capital.

But regulations have ramped up pressure on broker-dealers, Hancock added. The Volcker Rule mandated by Dodd-Frank, which was approved this month by federal regulators, restricts banks from trading their own money. Though municipal securities are exempt, tender option bond programs are not, and the rule will compel broker-dealers to limit risk on their own portfolios.

The pressure on broker-dealers will filter out into the market, Hancock said. Rising rates could precipitate outflows from bond funds, which pushes rates higher.

Cheaper bonds should, in turn, generate more demand, driving down rates. And lower rates may prompt issuers to come to market. But then more supply would again put pressure on yields.

But there are forces to counter this cycle, she added. Higher taxes in 2013 could encourage more investing in tax-exempts. Also, higher rates mean less incentive fewer refundings from issuers.

"So, if new-issue supply is limited," she said, "that's helpful."

The muni market won't enter 2014 with tailwinds, as it suffered through a down year by most measures. For starters, the average muni bond fund returned negative-3.658%, according to Morningstar, Inc.

The Bank of America Merrill Lynch US Municipal Master Index fell over the year to date. It underperformed the Treasury/Agency Index by 28.4 basis points, negative-2.919% against negative-2.635%, according to a Dec. 13 research report.

Demand suffered. Weekly reporting muni bond mutual funds recorded outflows of \$55.1 billion through the week of Dec. 11, the worst outflows Lipper FMI has seen. They far outpaced the \$15 billion in outflows funds reported in both 1994 and 2011.

Issuance has fallen 14.7% on the year through November to \$301 billion, compared with \$352.9 billion through the same period last year, Thomson Reuters numbers show.

Damaging credit headlines from Detroit, Chicago and Puerto Rico alarmed investors, particularly retail buyers, and applied an upward pressure to yields.

Triple-A tax-exempt yields on the year through Wednesday rose 93 basis points at the 10-year and 130 basis points at the 30-year. By comparison, the 10-year Treasury yield rose 105 basis points over the same span, while 30-year jumped 85 basis points.

Contemplating these storm clouds, muni participants expanded and contracted the lens when discussing other weak points in the market.

Given the dysfunctional nature of Washington, munis' bond with Treasuries and the interest-rate cycle remain their biggest issue, said Gene Gard, co-portfolio manager of the Dupree Municipal Bond Fund Family. But muni ratios to Treasuries present good news, he added.

"There's some cushion there," Gard said. "As far as municipal ratios to Treasuries, they're still pretty favorable in that, the ratio is above its historic normal range."

On the yield curve, the shorter part represents the most vulnerable segment when compared with the long end, said Ashton Goodfield, portfolio manager at Deutsche Asset and Wealth Management.

The yield curve for both tax-exempts and Treasuries should flatten out in 2014, she added, leading to outperformance at the long end.

“We think the short end, at the five-year, is much less attractive,” Goodfield said, “because of absolute yields and relationships to Treasuries, where the ratio’s about 79% five-year and 107% at the long end.”

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