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Reuters: U.S. Munis Rebound in January, But Rally Faces Tests Soon.

(Reuters) - U.S. municipal bonds have started the year strong, outperforming most other bonds and equities in a significant rebound from a dismal performance in 2013, when investors fled the sector.

After yanking a record \$62.6 billion from muni bond funds in 2013, investors have redeployed cash to the sector in January, with more than \$500 million over the past three weeks, Lipper data showed. Coupled with a limited flow of new issuance, that has helped boost the performance of munis across the board, especially in the high-yield sector, and could support more gains.

But hazards still lie ahead - a restructuring plan in the Detroit bankruptcy that appears to favor pensioners over bondholders and a threatened ratings downgrade on Puerto Rico, one of the \$3.7 trillion market's biggest issuers, could throw a wrench into the rally. Ongoing regulatory reform could pinch liquidity in a market already known for low trading volume.

Overall, munis tracked by the Barclays Capital U.S. Municipal Bond Index have delivered a total return of 1.93 percent in January, outpacing the wider U.S. bond market, as measured by the Barclays U.S. Aggregate Index, by 56 basis points.

"Munis came out of the box very strong," said Philip Fischer, head of muni bond research at Bank of America Merrill Lynch, who sees the rally extending in coming weeks against a backdrop of limited near-term supply.

The outperformance has been especially pronounced among lower-quality bonds with longer maturities.

The Merrill Lynch Triple-B U.S. General Obligation Municipal Securities Index, dominated by bonds issued by cash-strapped Puerto Rico, has delivered a total return this year of more than 5.5 percent. The Puerto Rico bonds in the index have gained 5.7 percent on a total return basis, index data show.

It is clear that investors are being drawn by the high-yield sector's enticing yields - the average effective yield in the Merrill index is nearly 8.5 percent compared with a 10-year U.S. Treasury yield of 2.65 percent. High-yield muni funds accounted for 90 percent of the latest week's inflows.

Some muni rebound is typical for January, when investors traditionally reinvest the coupons and principal payments that come due, according to Dorian Jamison, municipal analyst at Wells Fargo Advisors.

Issuance of new paper is also often low coming out of the holidays, leaving investors with little supply to satisfy their appetites.

The level of new deals coming to market in January fell to the lowest level in two years, to \$17.63 billion, as refinancing continued to dry up, according to preliminary Thomson Reuters data released on Friday.

Jamison was optimistic that munis could keep up the rally through the year, in part because their tax-free nature will continue to be a source of value in a time of higher federal taxes for wealthy investors.

RBC Capital Markets, for instance, projects that muni yields will tighten to Treasuries, an indication of outperformance.

The ratio of 10-year top-rated municipal bond yields to equivalent Treasuries could hit 90 percent by the end of the year from the current 95.5 percent, according to RBC. The 30-year ratio is forecast to reach 98 percent from about 107 percent now. A falling ratio signals muni outperformance.

But there are risks that could dampen the rally.

One big near-term threat is Puerto Rico. All three credit rating agencies have the island's bonds on watch for a possible downgrade into junk, depending in part on whether officials can successfully tap the muni market in coming weeks.

"The market is still fragile" with Puerto Rico and as headwinds, said Barry HoAire, a portfolio manager at Bel Air Investment Advisors in Los Angeles.

Federal regulation could also impede munis. Fitch Ratings has warned that a new rule governing high-quality liquid assets on bank balance sheets would hinder liquidity in the muni market if it were to be enacted as currently written.

U.S. banks, which hold about \$404 billion of the \$3.7 trillion of outstanding muni bonds, might reduce their muni holdings because the bonds would not be counted as high quality liquid assets under the new rule, Fitch said.

Furthermore, interest rates broadly are expected to rise, particularly as the Federal Reserve continues to reduce its massive bond buying stimulus that drove yields to record lows.

That said, the credit profile for issuers is brightening, with most states and cities seeing modest economic improvement and rebounding revenues from tax collections and fees.

"Yes, interest rates are going to go up. But there are improving credit fundamentals in all areas, even high yield," said Richard Larkin, credit analyst at HJ Sims in Boca Raton, Florida.

"Things are good - I am not expecting another major airline or auto manufacturer to go bankrupt. I think we have been seeing emotional and irrational reaction to municipal bonds."

BY HILARY RUSS

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