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Will the 2014 Muni Market Be Good for Issuers?

Analysts see a better year ahead, but say there are factors that could cause a 2013 repeat.

When he looks back at last year, George Friedlander, chief municipal strategist at Citigroup, sees it as “one of the most challenging years” on record for the municipal bond market. It was tough on the issuer and on the underwriting side, he said, citing a $65 billion outflow of investor money from bond funds last year (that’s up from $20 billion in the disastrous year of 2008). “The headwinds in terms of demand were as bad as we’ve ever seen,” he said at a recent Council of Development Finance Agencies forum on muni bonds.

Blame the latest run on funds on state and local pension problems, the bankruptcies of cities in California and, of course, Detroit, and concerns about Puerto Rico’s fiscal state. There was also the active threat that Congress would do away with the tax exemption on muni bonds. But the real culprit was fear that a decision by the Federal Reserve to back away from quantitative easing would lead to a spike in interest rates, said Friedlander.

So what about this year? Despite a host of risk factors still lurking, Friedlander and other muni market analysts think it looks a lot better.

Positive Vibes

“It is almost inconceivable that, before the next presidential election, the two [political] parties could agree on a major tax bill that would incorporate anything like a reduction in the benefit from tax exemption,” Friedlander said. In other words, unlike 2013, few analysts see the issue affecting the market significantly this year. That said, Tom Weyl, director of municipal research at Barclays, noted that munis are not as attractive to investors as they could be and that they would get a boost if tax reform were “taken off the table and eliminated as an option.”

The market also sees one of Judge Steven Rhodes’ rulings in the Detroit bankruptcy case as a positive. The ruling stated that federal bankruptcy law trumps the state’s constitutional protection of pensions, which means that pensions line up with other creditors for relief. “That pensions don’t have primacy was essentially good news” for the market, said Amy Laskey, a managing director with Fitch Ratings. But the ruling is likely to be litigated all the way to the U.S. Supreme Court, so the decision is far from final.

“We dodged a bullet,” Friedlander said, referring to the Volcker Rule. “If the rule came out in its original form, it would have disallowed proprietary trading in muni bonds and possibly put limitations on how banks market the muni bonds they own.” Instead, muni bonds are exempt under the Volcker Rule, and that means banks are likely to continue to be solid muni market customers. Still, regulatory issues remain, Friedlander says, “giving the market some agita.”

Finally, analysts are excited that direct retail investment started to come back last year. As Friedlander sees it, direct retail (as opposed to institutional investors) is a significant source of demand. If net supply of bonds will be negative, that means “investors are getting back as much in cash as issuance being generated or slightly more and that will create new demands going forward.”

Causes for Concern

The fiscal problems of Puerto Rico — negative economic growth, large deficits and a vastly underfunded pension — could be a drag on the market this year. Three-quarters of all bond funds hold Puerto Rican debt, so if Puerto Rico is downgraded, it could cause sale pressure and cause liquidity problems where lenders pull in lines of credit. “It’s not an imminent crisis,” Weyl said, “but these issues are out there [and] can cause market volatility. Headline risk creates a negative situation for the bond market. That’s why I’m concerned about an imminent Moody downgrade with large demands on Puerto Rico to stop the downgrade.”

Another concern is interest rate changes, which are always a threat and remain so for 2014. According to the Friedlander, depending on how strong the economy is and how much the Federal Reserve feels it is getting close to the time to raise short-term rates, there could be a significant change in Treasury yields and, consequently, a 40 to 50 basis-point increase in muni yields. On the other hand, there is a real chance the economy will undershoot, that growth will stay in the 2 percent range and that the Federal Reserve won’t accelerate its move out of quantitative easing. That means Treasury yields won’t go up significantly and muni yields will stay roughly where they are. “It’s definitely a bifurcated outlook,” he said. He thinks there is a 50-50 chance that rates will move up significantly but not disastrously, and that bond refundings that are in the pipeline will have room to get done. “We don’t see rates going hog wild on the upside,” he added. “[But] the lower an issuer is in credit quality, the more likely it is that rising rates will take you out of a refundable stance.”

Finishing On a Hopeful Note

As to the outflow of money from bond funds, Weyl noted that he and his fellow analysts at Barclays looked at a variety of factors in prior rate-rising environments and found that “this market looks and feels like 2004 and 2006. In those markets, after an initial rise in rates, fund flows returned. We’re not sure if that’s what we’re seeing now. Certainly, negative flows have slowed down. We think flows will return at some point this year.”

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