Muni Liquidity Suffering But Monoline Insurers Making a Comeback.

The municipal bond market has endured two detrimental downward trends since the financial crisis: the drying up of bond inventory held by banks and dealers, and the demise of monoline insurers, who once insured over half of the muni market. Robert DiMella of MacKay Municipal Managers, who manages the MainStay Tax-Free Bond Fund (MTBAX), says declining inventory will continue to pose a problem for market liquidity, but sees monoline insurers making a comeback this year.

DiMella calls the inventory reduction "very significant," noting that capital commitment to muni bonds by big banks has dropped to $9 billion as of June from $50 billion only two years ago, largely due to of tighter regulations and reduced risk appetite among banks. That can make it tougher to find a buyer when you want to sell, and it makes the market more susceptible to sharp swings in sentiment, like when munis saw protracted outflows last year following Detroit's bankruptcy filing and Puerto Rico's financial problems.

"This risk is going to stay with us," DiMella says, noting that other areas of the bond market face similar inventory issues. "We don't have big crossover buyers from other asset classes stepping in and absorbing technical imbalances. You have to run your operation with a greater amount of liquidity in your portfolio."

DiMella says the relatively recent advent of municipal exchange-traded funds "has exacerbated the problem, because you have a highly liquid product like an ETF that trades on an exchange investing in a less liquid muni bond."

DiMella identifies the re-emergence of monoline insurers as a key muni-market theme for the rest of 2014. These companies aim to maintain high credit ratings and "wrap" lower-rated, less liquid muni bonds for a fee, with investors benefiting from the higher credit rating, lower default risk and reduced need for individual credit research. But most monolines were felled by bad bets on mortgage securities during the financial crisis. DiMella says the market is re-emerging thanks to some favorable court rulings, with some companies achieving double-A ratings.

"The average retail investor is getting much more comfortable with insurers again when they see that they're not losing money in Detroit's wrapped bonds," he says, noting that MacKay has an overweight in insured munis.

Can DiMella imagine insurers regaining the same prominence they had before the financial crisis? "No," he says. "We don't foresee that, and don't foresee them getting back to triple-A ratings either."

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