## BlackRock Favors Long Bonds at Priciest Since 2012: Muni Credit.

When it comes to the longest-dated municipal bonds, value is in the eye of the beholder.

The securities are delivering the best returns in the municipal market as yields approaching five-decade lows lead investors to take on more risk. The gains have driven yields on top-rated 30-year munis to 0.92 percentage point above debt due in 10 years, the smallest gap since December 2012, data compiled by Bloomberg show. The bonds have also grown costly compared with federal debt: Last week, interest rates on benchmark 30-year munis fell below those on similar-maturity Treasuries by the most since May 2013.

Yet Peter Hayes, who manages about $122 billion as head of munis at New York-based BlackRock Inc. (BLK), isn't ready to call an end to the rally. If history is any guide, he has reason to stand his ground — the extra yield on 30-year munis shrank to as little as 0.6 percentage point in 2006 and 2007.

"Even given the magnitude of the flattening we've seen, there's still a lot of value in the long end," said Hayes, whose firm is the world's largest asset manager.

The $3.7 trillion municipal market is set to gain for the first eight months of 2014, an unprecedented streak that's driving benchmark yields toward the lowest since 1965. Investors are buying long bonds in the face of a Wall Street consensus that fixed-income yields will rise as the economy recovers.

**Forecasters' Bane**

At year-end, analysts at Morgan Stanley and Barclays Plc forecast rising interest rates and a second straight year of losses in 2014. In April, Citigroup Inc. and a range of fund managers suggested selling after the market's best quarter since 2011.

The drop in interest rates is a boon for issuers looking to lock in financing for decades. Longer-dated bonds typically command higher yields than shorter maturities to compensate for the added risk of the lengthier holding period. The gap approached a record high last year amid speculation that interest rates would rise as the Federal Reserve curbed bond purchases.

The median forecast in a Bloomberg survey of 50 analysts is for 30-year Treasury yields to rise to 3.83 percent at the start of 2015 from 3.13 percent now. In March, the projection for the same time period was 4.3 percent.

**Historical Context**

"Everybody was thinking about rates going higher and positioning portfolios for that type of scenario," Hayes said last week on Bloomberg Radio's "Bloomberg Surveillance" with Tom Keene and Michael McKee. "And what happened? Rates only have gone lower."

The current yield curve isn't unusual by pre-recession standards. From 2001 to 2007 the average difference in yield between 10- and 30-year munis was 0.92 percentage point.

The same can be said for the relationship between 30-year munis and Treasuries. The ratio of the yields, which ended last week at 99.6 percent, averaged 96 percent from 2001 through 2007, Bloomberg data show. The figure is a gauge of relative value and has historically been below 100 because investors are willing to accept lower yields to benefit from munis' tax exemption.

**Payoff Math**

For investors in the highest federal income-tax bracket, the 3.12 percent yield on AAA 30-year munis is equivalent to a taxable rate of about 5.2 percent.

"When you look back historically at how many basis points you're getting paid to move out the yield curve, it's still by historical standards fairly substantial," Hayes said.

In shorter maturities, state and local bonds are costlier than their federal counterparts.

Benchmark 10-year munis yield 2.2 percent, or about 92 percent of the rate on Treasuries. At the five-year maturity, the ratio is about 68 percent, the least since March 2010.

At Wells Fargo Advisors, Dorian Jamison doesn't see the need to look to longer maturities.

Bond buyers should consider seven-year AAA munis, which yield about 1.7 percent, because that represents more than half the rate of 30-year debt, he said in an Aug. 20 report. Another option would be 15-year securities, which yield more than 80 percent of bonds due in twice the time, he said.

For Hayes at BlackRock, betting on long bonds makes sense as municipal credit quality is improving while analysts have ratcheted back expectations for higher yields.

"People are a little less worried about rates going up in the near-term," Hayes said. "When you look at all the factors that can upset the market, most of them have been taken out."

By Brian Chappatta Aug 25, 2014 5:00 PM
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To contact the reporter on this story: Brian Chappatta in New York at bchappatta1@bloomberg.net

To contact the editors responsible for this story: Alan Goldstein at agoldstein5@bloomberg.net Mark Tannenbaum, Pete Young