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Supply-Demand Dynamics Should Support Muni Market.

Despite the headline news surrounding a small handful of municipal issuers, the muni market has performed well this year and remains underpinned by strong supply and demand dynamics. It's one of the key themes identified by the MacKay Municipal Managers (MMM) team at the beginning of the year and, if anything, it's playing out even more decisively than they predicted.

First: the supply side. New muni bond issuance is heading for all-time lows. In the first six months of 2014 it was 15% below year-ago levels. Continued austerity measures mean that state and local governments are issuing less debt. We have seen municipalities bypass issuance in the bond market because they're getting increasingly favorable terms on direct loans from banks.

Meanwhile, demand has come roaring back. Institutional investors (life insurance companies, pension funds, total return taxable bond funds etc.) have been the first to flock into the muni market this year, drawn by attractive yields. More recently, retail investors have followed. We have now seen around $9 billion in net positive municipal mutual fund flows, compared with $70 billion in net outflows in 2013 when investors were spooked by events such as QE tapering, rising rates and headlines related to Puerto Rico and Detroit.

So the scenario we're facing is more investor money chasing a smaller pool of available bonds. The amount outstanding in the muni market is expected to shrink for the third consecutive year. Expectations were for net negative supply at $29 billion in 2014, but the MMM team thinks the contraction could be more than that.

Much of the retail demand is coming from baby boomers, who have now begun transitioning towards retirement and are increasingly looking for tax-exempt income. They are realizing that higher taxes on both earned and unearned income have resulted in an increase in the value of tax-exempt municipal bonds. Income tax rates at both the federal and state level have risen about 24% over the last two years, while capital gains taxes have risen 60%. As I have discussed in an earlier post, higher taxes make munis more attractive. "Investors are recognizing that the taxable-equivalent yields on muni bonds are exceeding historical equity returns while maintaining very low default rates," says Bob DiMella, co-head of the MMM team.

The volatility around Puerto Rico's debt restructuring is a reminder that investment in credit sensitive markets requires professional guidance. As we've seen consistently with headline news in the muni market, the tide rises and falls and, with the right credit work, the market offers relative value opportunities to active managers.

Overall, we've seen attractive returns year-to-date. For example, the Barclays Municipal Bond Index returned 6.18% through July 31. All else being equal, the supply/demand picture is likely to continue to support returns going forward.

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