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BlackRock Sales in October Rally Signal Its Limits.

The municipal-bond market's rally this year has confounded Wall Street expectations, culminating in the best October performance since 2001 and drawing the most cash in two years. BlackRock Inc. (BLK) has had enough.

After an unprecedented nine straight months of muni gains, the world's biggest money manager said it sold some of the debt as benchmark yields sank to a 16-month low. Vanguard Group Inc. also says the market is vulnerable to losses at current levels.

Munis have earned 1.2 percent this month, on pace for the biggest October gain since a 1.4 percent return in 2001, according to Bank of America Merrill Lynch data. While municipal issuers may welcome diving borrowing costs, investors are growing wary of buying as yields approach generational lows.

"We've taken a little bit off the table in the last few days," Peter Hayes, who oversees $122 billion as head of munis at New York-based BlackRock, said in an Oct. 16 interview. "Nobody really expects rates to rally significantly from here. In fact, I think everybody is waiting for a little bit of a pullback. That's what we'll wait for."

Outlier Rally

Benchmark 10-year muni yields have increased 0.03 percentage point since touching 1.94 percent on Oct. 16, the lowest level since May 2013, Bloomberg data show. They started 2014 at 3 percent.

This year's return for munis has defied forecasts of analysts and investors in the $3.7 trillion market. Morgan Stanley's main scenario for 2014 was for losses of at least 1.7 percent, while Barclays Plc estimated a 1.45 percent drop. In April, Citigroup Inc. joined the chorus of those advocating sales.

Instead, munis have rallied in each of the first nine months of 2014, a feat that hasn't been seen in the past 25 years, according to Bank of America data.

States and cities across the U.S. are taking advantage of lower rates to finance projects or refund higher-cost debt.

New York won the lowest borrowing costs in at least half a century last week when it issued 30-year sales-tax bonds at a yield of 2.87 percent, according to the state budget office. It added $150 million of debt to the deal because of the reduced rates.

Carolina 'Jackpot'

South Carolina's public-service authority, known as Santee Cooper, borrowed an extra $186 million amid the falling interest rates, said Chief Financial Officer Jeff Armfield.

In Florida, Miami-Dade County Public Schools "hit the jackpot," said Treasurer Leo Fernandez. The district's refinancing will save almost $24 million, compared with the projected $14 million, he said

in a telephone interview.

Municipalities across the country have scheduled about $10.5 billion of sales during the next 30 days, the most in four weeks, Bloomberg data show. State and cities have issued $219 billion of fixed-rate, long-term debt this year, 8 percent below last year's pace, helping stoke the rally.

"Munis are fully valued, overbought and potentially exposed to a backup, particularly if we get heavy supply over the remainder of the year," said Chris Alwine, who oversees $140 billion of state and local debt as head of munis at Vanguard in Valley Forge, Pennsylvania.

2012 Echo

While Vanguard isn't selling bonds to raise cash, it's looking for debt that will retain value better in declines, Alwine said. He said current yield levels echo the end of 2012, when interest rates fell to the lowest since the 1960s before rising amid the worst yearly losses since 2008.

Morgan Stanley, which predicted 2013's decline, is again projecting losses. The bank's main scenario is for the market to lose 0.88 percent in the next 12 months, Michael Zezas, its chief municipal strategist, wrote in an Oct. 6 report.

The consensus on Wall Street is for yields to rise as the economy strengthens. Ten-year Treasury yields will reach about 3.2 percent in the third quarter of 2015, about a percentage point above current levels, according to the median forecast of 76 analysts in a Bloomberg survey.

Tim McGregor at Northern Trust and Jamie Pagliocco, director of bond managers in Merrimack, New Hampshire, at Fidelity Investments, aren't so quick to call an end to the rally as individuals have added to muni mutual funds for 14 straight weeks. It's the longest stretch since October 2012, Lipper US Fund Flows data show.

Cash Influx

The influx may absorb new deals for the remainder of the year and keep yields near current levels, the asset managers say.

"We've got four to five solid weeks of supply ahead, but it seems like there's cash to make it through that without too much adjustment," said McGregor, who oversees $30 billion as head of munis at Northern Trust in Chicago. "I would still count on a lot of volatility along the way."

Relative value may stand in the way of a sustained muni rally: The debt has outperformed some major fixed-income counterparts this year. While state and city bonds have gained 9.7 percent, Treasuries have earned 5.5 percent and investment-grade company securities have returned 7.6 percent, Bank of America data show.

As a result, the ratio of 10-year muni yields to similar-maturity Treasuries has dropped to 90 percent, compared with a five-year average of 98 percent, Bloomberg data show. The lower the figure, the costlier state and local debt is in comparison with federal obligations.

For BlackRock, which said in an outlook in December that munis entered 2014 "reasonably valued," that's no longer the case.

"I'm not sure the municipal market is priced right," Hayes said. "You can use strength like we've seen to sell into it, put cash on the sidelines and wait for better opportunities down the road."

Bloomberg

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Oct 20, 2014 7:06 AM PT

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