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Market Cools to High-Yield Munis.

Investor demand for municipal high-yield securities has been muted for the past month as preoccupation with rising interest rates and the stigma surrounding speculative credits outweigh the lure of wider-than-average spreads, according to two market analysts.

They say the ongoing uncertainty over interest rates, bulging supply in the investment-grade sector, and the negative performance of credits such as tobacco and Puerto Rico, are distracting investors from the municipal high-yield market.

The spread between the S&P Municipal Investment Grade and S&P High Yield indices has widened to 407 basis points as of March 19, an indication of value in the municipal high yield sector, said Stephen P. Winterstein, managing director of research and chief municipal strategist of municipal fixed income at Wilmington Trust Investment Advisors Inc., in a March 17 report.

The spread, he said in a March 19 interview, is "fairly compelling" compared with the past three-years, during which spreads tightened to 217 basis points in February 2013 and were as wide as 421 basis points in August 2014.

The spread is more attractive than other fixed-income alternatives, but that doesn't seem to be enough to attract many investors who are waiting on the sidelines, according to Jim Colby, senior municipal strategist at Van Eck Global.

As if the expectation for higher interest rates had not already provoked uncertainty and volatility in the fixed income markets in general, the suggestion of yet another delay from the Federal Open Market Committee last week is exacerbating the torpor in the municipal high-yield market, Colby said in an interview on March 19.

"That played into investors taking a step backward and waiting to see if rates do indeed rise and then return to the high-yield world," he said.

The removal of the word "patient" from the FOMC's language at a meeting on March 18 caught the market off guard, Colby added.

"The market was preparing itself for a different outcome" other than Fed chairman Janet Yellen indicating a possible June time frame for an initial increase, Colby said. "The market was more prepared that the Fed was going to raise rates in April," he added.

Yellen said given the continued improvement in economic conditions, the Fed doesn't want to rule out the possibility that an increase in the target range could come at subsequent meetings to the April FOMC meeting.

"Today's modification of our guidance should not be interpreted to mean that we have decided on the timing of that increase," Yellen said. "In other words, just because we removed the word 'patient' from the statement doesn't mean we're going to be impatient."

The latest in a long line of delays has curtailed trading activity and demand for municipal high-yield over the last four to five weeks, Colby said — except for some limited trading volume among professional money managers.

“We really haven’t seen any activity or any interest in the high-yield space since a mid-February time frame” when the market traded off slightly and new issue supply in the investment-grade space increased amid ongoing uncertainty about rates, he said.

Colby said neutral flows into Van Eck’s own Market Vectors exchange-traded fund products in particular are a barometer of recent non-activity in the municipal high-yield sector.

“Market-makers are biding their time waiting for indications of interest on the investor side,” Colby said.

There has been no new net cash to put to work, he said, adding that flows into the ETFs have “flat-lined” so far in 2015 – which is consistent with last year.

Colby noted that the Barclays Municipal High Yield Index is up just 1.53% and the Van Eck High Yield Index is up 2% year to date as of March 19 – but said much of that growth accrued back in January, when the market presented a strong tone after the fourth quarter.

Any growth has been minimal since then, as “the market is struggling to find indexes that are showing much more than just a minor positive profile in terms of returns,” Colby said.

In addition, the uncertainty over the timing of a planned Puerto Rico Infrastructure Finance Authority sale could further slow the municipal high-yield market, Colby noted.

The deal, which has been postponed more than once, could reportedly come as large as $2.95 billion.

“Without that $3 billion deal floating into high-yield, the rest of the supply in the high-yield marketplace will likely get more attention and prices are likely to rise because there isn’t an immediate substitute on the horizon,” Colby said.

Still, in the meantime, the municipal high-yield sector is “very favorable,” he added. The value is derived from the technical factors – including the after-tax comparison to other fixed income asset classes, as well as to corporate high-yield securities, according to Colby.

“The ratio comparison of municipal high yield to corporate high yield at 106.97% 9 [as of Feb. 27, 2015] suggests that municipal high yield – not even adjusted for taxes – is nominally higher,” he said.

That was up from 96.28% as of Jan. 30, and is compared with an average of 83.12% dating back to March 31, 2005, according to data from Van Eck and FactSet, an independent financial and analytical data firm cited in Colby’s report.

The ratio peaked at 136.05% as of June 30, 2014, the data showed.

Winterstein warned that the spread widening comes with a caveat.

The S&P municipal high-yield index is comprised of 26% of Puerto Rico bonds and 15% of tobacco paper — two of the market’s riskiest sectors, he pointed out.

"Investors should have little to no Puerto Rico or tobacco exposure," given their track records, he said.

Puerto Rico Gov. Alejandro Garcia Padilla has come under fire for his proposed tax overhaul, which includes a shift from a 7% sales tax to a 16% value added tax to help the commonwealth pay debt service.

While tobacco bonds provided some of the highest returns in the municipal market in 2014 and yields soared during a sell-off in the fourth quarter after Bill Gross' departure from PIMCO, as structured finance instruments, they are also sensitive to high-yield corporate funds, traders have said.

"With domestic consumption rates in a secular decline," Winterstein said of tobacco. "We don't think the long-term economics support the sector."

A new $1.7 billion tobacco deal from California's Golden State Tobacco Securitization Corp. is planned for pricing by Citigroup Global Markets on March 24. The bonds are rated A1 by Moody's Investors Service, AA by Standard & Poor's, and A by Fitch Ratings.

THE BOND BUYER

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