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Municipals Should Turn Around This Summer, Experts Say.

The recent volatility and weak demand in the municipal bond market, caused in part by problems in Chicago, Illinois and Puerto Rico, should soon begin to turnaround this summer.

This was the contention of bond officials at Thursday's BlackRock's Municipal Bond Roundtable in Manhattan. The recent problems in municipals, such as Chicago's downgrading to junk status and Puerto Rico's long-term payment problems, partly led to S&P Municipal Bond Index Yield dropping by 0.21 percent in May. That resulted in the third consecutive month of net outflows.

But this is creating an opportunity for munis, Black Rock officials said.

"The upside to a third down month is that the correction has created levels (higher yields and ratios) not seen in many months. We expect that this will attract both retail and non-traditional buyers back to the tax-exempt class," BlackRock officials wrote in their latest municipal market update.

Peter Hayes, head of BlackRock's Municipal Group, reviewing the last three months in which munis have been outperformed by Treasurys, now predicted a "positive return" for municipals. He said munis had reached a "relative value bottom."

However, he warned that Puerto Rico is still problematic. Puerto Rico Electric Power Authority is still seeking to find a solution through $1 billion in savings from stakeholders, but it is possible that it might ask bondholders to take a haircut.

Still, June is a transition month in which the municipal bond market as a whole should begin to turn around, added Sean Carney, BlackRock's head and director of Municipal Strategy.

"The underlying tone of the market feels better than it has in the past several weeks," he said. Still, he added it will probably take until July, August and September to see better performance. "It does feel as though demand will come back to the market if we can get some rate stability," Carney said.

BlackRock officials said how the Federal Reserve raises rates — slowly or quickly — is more important than rate hikes, which the market is already anticipating. Carney predicted that, after several years of net refundings in munis, 2015 will be a net issue year.

BlackRock officials offered these overweights and underweights.

Overweights

- State tax-backed and essential-service bonds, particularly in the Southwest and Southeast regions.
- School districts
- Dedicated-tax bonds

Underweights

- Puerto Rico and its authorities

• Local tax-based issues, particularly in Alabama, Nevada and Arizona.

FINANCIAL ADVISOR

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