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Munis' Rare June Fund Exodus Compounds Worst Quarter Since 2013.

This is normally a time of year when the individuals who own the majority of municipal debt collect coupon and principal payments and direct the cash back into the market. This year, they appear to be taking their money elsewhere.

Assets in muni mutual funds fell by \$381 million in the week through June 3, the fifth-straight outflow, according to Lipper US Fund Flows data. It was only the second time in a decade that the funds have shrunk at the start of June, in part because it coincides with a period when investors get paid from maturing debt and interest. Taxable funds pulled in about \$1.2 billion.

The exodus signals weakening demand in a market dominated by investors who tend to buy bonds, hold them to maturity and roll them over into new securities. Tax-exempt debt has lost 1.4 percent since March 31, Bank of America Merrill Lynch data show. It's on pace for the largest quarterly drop since the same period of 2013, when Detroit's move toward bankruptcy and speculation that the Federal Reserve was close to paring its bond-buying prompted unprecedented withdrawals.

"You would expect to see a better top-line number for the first week of June," said Chris Mauro, head of muni strategy at RBC Capital Markets in New York.

Individuals' Sway

Individuals own about 60 percent of munis either through specific bonds or mutual funds, giving them outsized sway over the market's performance.

The latest withdrawals, the largest since tax-related outflows in the week through April 15, were surprising because of the estimated \$35 billion bondholders are set to receive, Mauro said.

This month's payments will probably be the year's third-highest, behind July's \$44 billion and August's \$38 billion, he said.

Munis are joining a selloff in global bonds as signs of economic strength fuel bets the Fed will raise borrowing costs as soon as September. The recent fund outflows aren't as severe as the \$1 billion or more seen almost weekly during the 2013 fixed-income rout dubbed the "taper tantrum."

Since the biggest yield increases in that 2013 episode took place later in June, it may be too early to count out a repeat of that event, Vikram Rai, head of muni strategy at Citigroup Inc. in New York, wrote in a June 8 report.

'Added Burden'

"Muni price volatility is first and foremost a function of Treasury volatility, but we have the added burden of facing some outflows," said David Manges, manager of municipal trading at BNY Mellon Capital Markets LLC in Pittsburgh.

The deteriorating finances of issuers including Puerto Rico, New Jersey and Chicago have also dimmed the appetite of some bond buyers, said Alan Schankel, managing director of fixed-income strategy at Janney Montgomery Scott LLC in Philadelphia.

Benchmark 10-year muni yields climbed to 2.39 percent Tuesday, the highest since July 2014, according to data compiled by Bloomberg.

Demand for tax-free income is shielding munis from the worst of the global bond losses. Their quarterly decline is more muted than losses of 2.2 percent for Treasuries and 2.6 percent for investment-grade corporate debt, Bank of America data show.

“In the total fixed-income world, munis have more appeal than other sectors mostly because of high tax rates and their high after-tax returns,” Schankel said.

Yet even amid the stretch of fixed-income declines, investors have poured money into funds focused on taxable bonds, adding \$15.4 billion over the last eight weeks, Investment Company Institute data show.

“Hopefully this is not like 2013, where the outflows become more substantial,” said Manges at BNY Mellon.

Bloomberg

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June 8, 2015 — 9:01 PM PDT Updated on June 9, 2015 — 8:32 AM PDT