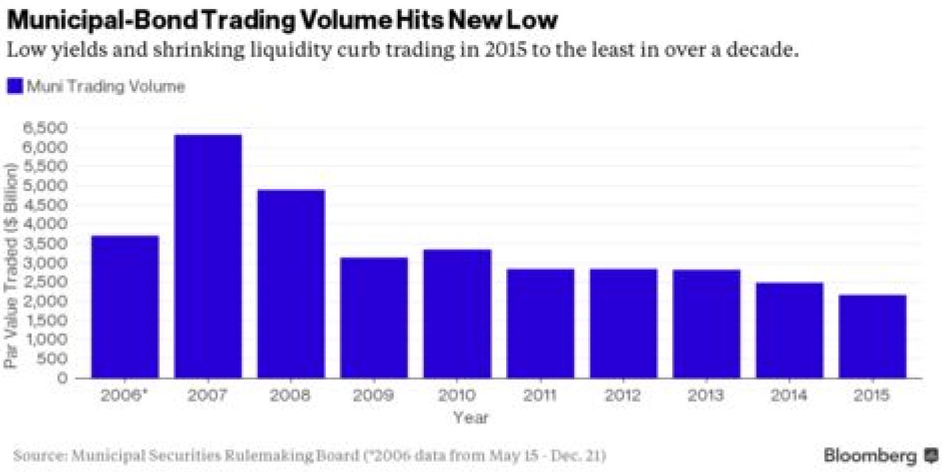
Bond Case Briefs

Municipal Finance Law Since 1971

Muni Investors Who Got 2015 Right Seek Gains in Market's Swings.

MacKay Shields's John Loffredo and Robert DiMella made five predictions for the municipal-bond market in 2015, and they all came true. This year, the co-heads of munis at the $90 billion investment firm expect a liquidity tug-of-war to create profit-making opportunities.

With trading growing thinner and securities dealers pulling cash from the market, muni prices are at risk of being whipsawed if investors rush for the exits, the money managers said in an interview. Such a run could be brought on by rising interest rates, Puerto Rico's escalating fiscal crisis, or credit-rating cuts to perpetually struggling states such a New Jersey, Illinois and Pennsylvania. A scare, they said, would provide a chance to pick up bonds on the cheap.



The weaker liquidity means "volatility is going to be higher, movements in the market are going to be greater than they historically otherwise would've been," said DiMella, whose company had two of the 10 best-performing open-end muni funds in the past year. MacKay, a unit of New York Life Insurance Co., oversees $14.5 billion of the securities.

"For us, it's not run for the hills," DiMella said. "Take advantage of it, especially in a marketplace that investors on average don't look to take advantage of any type of dislocations."

Trading volume in the $3.7 trillion market shrank in 2015 to the lowest level in at least a decade, according to data from the Municipal Securities Rulemaking Board, with about $2.2 trillion of bonds changing hands. That's one-third of the peak in 2007, before the financial crisis caused dealers to cut their holdings of tax-exempt securities by 76 percent.

The muni market is divided among tens of thousands of borrowers and the majority of debt is held by buy-and-hold investors, who are looking for steady, tax-free returns. That's long made it less liquid than the Treasury and corporate markets.

Sometimes that works in the bonds' favor, like when they outpaced most other assets in a tumultuous 2015. At other times, it doesn't: The market was pummeled in late 2010 following speculation that the recession's impact would trigger rising defaults, and again in mid-2013 because of concern that the Federal Reserve was poised to begin tightening monetary policy.

Wilder Ride

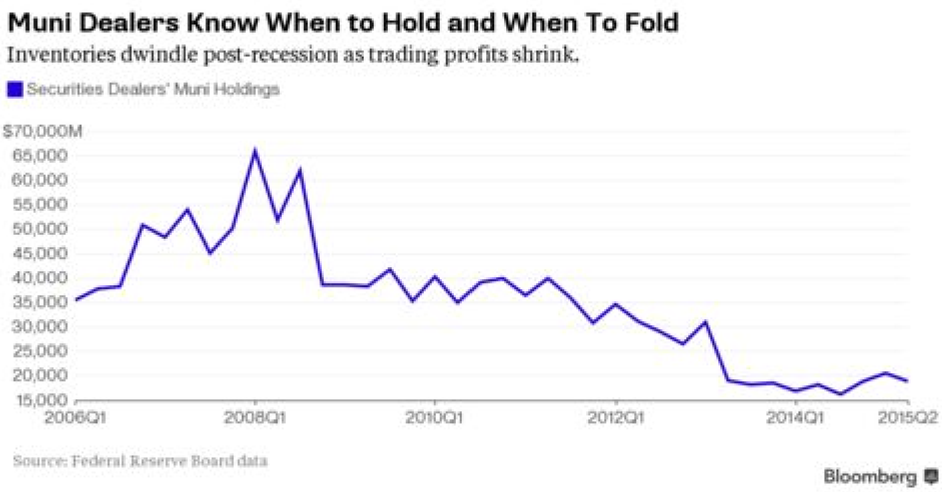
MacKay's Loffredo and DiMella said price swings are more likely to occur in 2016 and will be more severe when they do.

During the first week of the year, munis rallied as the ripple effects of slowing growth in China led investors to seek safe havens. Benchmark 10-year muni yields had their steepest decline in almost four years, dropping 0.16 percentage point to 1.84 percent, an 11-month low.

If the pendulum shifts, the lack of trading could increase stress on the market. The average daily volume for municipal bonds is less than 2 percent of what it is for Treasuries and less than half that of corporate debt, according to the Securities Industry and Financial Markets Association.

Trading has declined every year since 2010, according to the MSRB's statistics. At the same time, dealers cut their muni holdings to about $16 billion at the end of September from as much as $66 billion in early 2008, according to Fed data, as regulations and narrower profits due to low interest rates led banks to devote less capital to the market.

"What we started seeing somewhat over the last five years is exacerbating in 2016," Loffredo said.



MacKay's MainStay California Tax Free Opportunities Fund returned 5.5 percent in 2015, beating 98 percent of its peers, while its MainStay High Yield Municipal Bond Fund exceeded 85 percent of its competitors with a 5.6 percent gain. The two were among the 10 best over the past year, according to data compiled by Bloomberg.

Among the firm's other forecasts: Revenue bonds will outperform general obligations, and transportation debt, such as those sold by airports and toll roads, will be one of the top-performing segments. The demand for new securities will be more closely tied to the amount of money flowing into the market than in the past. And high-yield, which posted the top returns in 2015, will extend gains in the first half of the year, only to trail investment-grade debt for the next six months.

Good Calls

Loffredo and DiMella's calls last year proved prescient.

They predicted high demand for tax-exempt debt, which held true as individuals poured $13 billion into muni mutual funds throughout 2015, Lipper US Fund Flows data show.

They called for top-rated short-term debt to lag the market. That debt earned 0.7 percent last year, compared with 3.6 percent for the broad market, Bank of America Merrill Lynch data show.

They thought issuance would exceed expectations. It did, ending at the highest level since 2010.

They bet that tobacco bonds, one of the riskiest corners of the market, would be one of the top performers. The debt surged 13.5 percent, almost four times the returns of munis broadly, S&P Dow Jones Indices data show.

With a track record like that, muni investors may do well to prepare for what MacKay calls "liquidity wars" in 2016.

Bloomberg Business

by Brian Chappatta

January 7, 2016 — 9:01 PM PST Updated on January 8, 2016 — 5:47 AM PST