Investors Opt for Munis as Stocks, Commodities Plunge.

Municipal bonds are getting a boost as investors look for stability after international and domestic equity markets tumbled.

"A lot of things are going right for our asset class here at the beginning of the year," Jim Colby, senior municipal strategist and portfolio manager at Van Eck Global, said in an interview on Tuesday. Municipals are benefitting from the asset reallocation by investors after the Chinese stock market sold off on concern over an economic slowdown, he said.

The Dow Jones Industrial Average on Jan. 13 was down almost 10% from its highs of late last year, as investors flocked to safer assets.

"With China seemingly in a downward spiral having suspended their stock trading and with oil seemingly in a free fall, and equities down 5% to 6% at the start of the year, some advisors are saying munis are a spot of choice – at least right now – not just domestically, but worldwide," Colby said.

Demand for municipals – including the $3.7 billion of assets in Van Eck's Market Vectors suite of municipal ETFs overseen by Colby – has surged.

"It's been a wild two and half to three weeks" thanks to a significant amount of cash inflows in a short period of time, he said. "We have seen quite a bit of cash come into the ETFs here, and I can't remember a recent January that was quite this way.

"Given everything that is happening right now, the muni marketplace with its low volatility and high credit quality has to remain right up there at the top of anyone's list as the asset of choice," Colby said.

On Jan. 13, 10-year municipal bonds were yielding 86.2% of their 10-year Treasury counterpart, while the ratio of 30-year municipals to comparable Treasuries was 95.6%, according to Municipal Market Data. Those ratios compare with averages of 89.9% and 98.8%, respectively, over the three month period between Oct. 22 and Jan. 13, according to MMD.

Colby said the attractive ratios add to the sector's appeal.

Even though his ETFs seek to mirror and/or track the performance of a selected benchmark index instead of investment strategies used to achieve performance and value on its own, Colby said he does have some advice for investors.

He said in the midst of the reallocation trend the long end of the municipal market should be favored not feared, especially as the Federal Reserve Board has begun its slow and steady pace of raising rates.

"Don't fear the long end of the market," Colby said.

Although it has been 10 years since the Fed last began raising rates aggressively, when that phenomenon took place back in 2006, the long-end remained relatively stable while the short end gave ground, Colby recalled.

“The performance lay in munis 10 years and longer – and little damage was done in duration extension,” the strategist said.

Colby said the long end of the yield curve finished 2015 with evidence of strong performance.

In fact, municipal bond outperformed Treasuries and corporates in December and emerged as the best-performing fixed income asset class of 2015, according to BlackRock Inc. in its municipal market update dated Dec. 31, 2015.

Municipals were “propelled once again by favorable supply-demand dynamics,” BlackRock analysts Peter Hayes, Sean Carney, and James Schwartz wrote in the report.

The S&P Municipal Bond Index returned 0.71% in December and 3.32% for 2015, making it the leading fixed income asset class of the year.

The long end of the curve led performance monthly in December with returns of 1.08% and 4.45% year to date, while the intermediate range was also attractive as it returned 0.62% for December and 3.27% year to date, according to the S&P data used in BlackRock report.

“The yield curve flattened significantly, with the short end rising as the Fed lifted its target short-term interest rate for the first time since 2006 and the long end holding steady as global growth disappointed and oil prices approached a six-year low, muting inflation expectations,” the analysts wrote.

Hayes is the managing director and head of the municipal bonds group, Carney is the director and head of municipal strategy, while Schwartz is the managing director and head of municipal credit research.

Going forward, Colby believes that history will repeat itself.

“Once there is a clear path for the Fed to raise rates in a regular fashion and wages start to lift a little bit to compliment the strength in the labor force and auto and housing industries, then the Fed might feel more empowered to raise rates,” Colby said.

However, with an ongoing series of rate increases dependent on further economic and wage growth, Colby said the intermediate part of the curve is an attractive and stable alternative in the meantime.

“There’s plenty of bonds in this part of the curve; deals come with significant tranches in 10 to 15 years, and the yield curve is still steep, so you can find opportunities to position yourself where you are getting incremental returns relative to the two ends,” Colby said.

The 10-year triple-A general obligation scale on Jan. 13 yielded 1.78%, while the 15-year part of the scale yielded 2.22% — both unchanged from the day before, according to MMD.

“Banks like that part of the curve, and insurance companies like that part of the curve,” Colby said. “They tend to buy at whole prices in a relatively steady market environment.”

He said this is part of the attractiveness of tax-exempt securities as investors seek cover from volatility outside the municipal world, Colby noted.

“Given the relative attractiveness and low volatility of the asset class as a whole, the strategy ought to be to continue to keep your foot in the game with munis,” Colby said.

The BlackRock analysts share a similar view.

“We have a constructive outlook for municipals in 2016 given their high-quality nature and unique ability to provide tax-free income and solid risk-adjusted returns with less volatility than other fixed income assets,” BlackRock’s analysts wrote.

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