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The High-Yield Munis That Conquered 2015 Seen Overpriced in 2016.

For investors in high-yield municipal bonds, the downside of making money in 2015 while other risky-debt buyers suffered losses is they'll be hard-pressed to do it again in 2016.

Junk-rated munis returned 1.8 percent last year, in contrast to declines of 0.8 percent, 4.5 percent and 22 percent for U.S. high-yield loans, corporate securities and floating-rate notes, respectively, Barclays Plc data show. Energy companies dragged down returns as oil prices continued to slide, raising the risk of defaults. Taxable company debt is down another 2.2 percent this month through Jan. 27, while tax-exempt bonds gained an added 0.1 percent.

The divergence can't last, say Standish Mellon Asset Management and Wells Capital Management. State and local bonds benefit from stronger credit quality than their corporate counterparts, leaving investors more willing to lend to lower-rated borrowers to pick up extra yield with interest rates near generational lows.

Only 7.5 percent of tax-exempt debt rated junk by Moody's Investors Service defaults within 10 years, compared with 32.4 percent of corporate securities. Yet this year may come down to what's cheap and what's not.

"We're at a crossroads," said Lyle Fitterer, head of tax-exempt debt in Menomonee Falls, Wisconsin, at Wells Capital, which oversees \$39 billion of munis. "If you go back five years, there's been fairly substantial underperformance of high-yield taxable versus high-yield munis. We'd argue that valuations within the high-yield taxable market look pretty attractive and you're going to get excess performance."

Mutual fund investors aren't getting the message. U.S. corporate high-yield funds saw outflows of more than \$4 billion in the past two weeks, Lipper US Fund Flows data show. By contrast, individuals have poured \$1.5 billion into high-yield muni funds over the past five weeks, the biggest wave of cash since June 2014.

So-called crossover buyers, who don't benefit from the tax-exempt interest on municipal bonds yet sometimes buy it anyway when it gets too cheap, are in the best position to capitalize and add high-yield corporate debt, Fitterer said.

That could come at the expense of individual investors, who hold the majority of munis through private accounts or mutual funds. They have shown signs of chasing performance by pouring money into the market when it's rallying and yanking it during routs.

That's particularly risky when it comes to the high-yield muni market. Apart from bonds backed by tobacco settlement money, many of the securities were issued for small, stand-alone projects. On some occasions, a few investors own the entire deal.

"We are at rich valuations in muni high-yield and we're more likely to revert to the mean to look

more like corporate high-yield, so it wouldn't be the time in the cycle to buy," said Christine Todd, head of tax-sensitive strategies at Standish Mellon, which oversees about \$30 billion in munis. "When you own municipal high-yield, you do have a danger of finding yourself owning illiquid securities that can't be traded."

That risk came to fruition in 2013, during what became known as the Taper Tantrum. The \$1.9 billion Market Vectors High Yield Municipal Index exchange-traded fund, used as a proxy for the market, tumbled 14.3 percent in a month from its near-record high. It still hasn't recouped the price decline.

Other investors, including Nuveen Asset Management, aren't as quick to call an end to the current rally.

While the bonds appear expensive relative to alternative assets, so does the municipal market as a whole: The ratio of benchmark 10-year AAA yields to U.S. Treasuries tumbled this month to the lowest since 2011, signaling that state and local debt is relatively pricey. That means high-yield securities, with larger interest payments to offset any price declines, could still fare best among tax-exempt obligations.

"The relative value versus corporate high-yield really represents the blowing out of spreads in corporate high-yield," said John Miller, who runs Nuveen's \$11.8 billion high-yield muni fund, the largest of its kind. Riskier tax-exempt bonds are still attractive because "defaults are running below average and AAA yields are also running below average, but tax obligations for the highest income brackets are the highest since 1986."

While the high-yield muni market is alluring for wealthy investors after adjusting for taxes, the low-hanging fruit is gone and few segments are worth the risk at current prices, Pacific Investment Management Co. portfolio managers David Hammer and Sean McCarthy wrote in a Jan. 24 report. The company's \$626 million high-yield muni fund outperformed 99 percent of peers over the past year. They're adding debt with stronger credit ratings.

"Increased volatility can present great opportunities for investors who are well-positioned, but it also can be a land mine for those who aren't," Hammer and McCarthy wrote. High-yield municipal debt investors should be "equipped to play defense if conditions warrant."

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