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High-Yield Muni Sector Thrives on Inflows, Low Volatility.

Inflows should remain steady and continue to fuel the municipal high-yield sector, where strong performance, attractive spreads, and low volatility are boosting demand while other fixed income asset classes languish, municipal experts said this week.

At the same time, the sector has also seen the arrival of "fallen angels," as formerly investment grade credits like Chicago became part of the speculative market, giving investors more options.

With performance thriving and volatility trending lower, heavy demand has pumped cash into high-yield municipal bond funds for the past 22 weeks to extend the sector's more than two-year recovery, while other fixed-income sectors, like corporate bonds, have sold off.

"Most of the returns are being driven by the income, and the stability is noteworthy this year as well," John Miller, co-head of fixed income at Nuveen Asset Management told The Bond Buyer on Tuesday.

Municipal high yield mutual funds have three month total returns of 1.65%, year to date of 1.06%, and 4.46%, 3.71%, and 7.22% over one, three, and five years, according to Morningstar data as of Mar. 9.

Excluding Puerto Rico, defaults have been low in the municipal high yield arena, and that has moderated redemptions and boosted demand, according to the Miller, who manages municipal funds with about $20 billion of assets, including a high-yield municipal portfolio.

"There is less of a compelling reason to redeem," he said.

Despite some spotty selling pressure during individual weeks or months, he said the municipal high-yield sector in general has been on a recovery path since the end of 2013 – and remains on that path.

"2014 was a very strong year, and 2015 was much more of earning your income and coupon and also low volatility, good demand, good liquidity and low default, and 2016 looks a lot like 2015 so far," Miller said. "Investor inflows to high-yield muni product are consistently positive alongside municipal products in general" so far in 2016, he continued.

Additionally, Miller said while the sector's low supply pales in comparison to corporate issuance of roughly $1 trillion a year, there are increasing defaults in the corporate bond market and added volatility from its exposure to the low oil prices and oil and gas exploration and production.

The municipal high-yield sector by comparison has less exposure, he said, to the more highly energy-intensive sectors that are affecting the corporate market – even though there isn't as high a corollary in the municipal market.

Overall, the scenario of strong market technicals should lead to many additional weeks of inflows in the near-term as demand for the product grows under the current positive market conditions, experts said.

Triet Nguyen, managing director and group co-head of NewOak Fundamental Credit, said the technicals for the sector have been bolstered by steady inflows into high-yield municipal funds, though the inflows tapered off last week.

High-yield municipal funds reported inflows of $27.310 million for the week ended March 2, after inflows of $245.834 million the previous week, according to Lipper data. Experts said the inflows probably result from seasonal shifts in assets ahead of the April 15 income tax deadline.

Weekly reporting municipal bond funds attracted $212.25 million in the week ended March 2, after inflows of $696.39 million in the previous week, Lipper said.

Nguyen said scarcity and investors' growing confidence in the U.S. economic outlook has helped insulate the high-yield municipal market from this year's sell-off in the corporate bond market.

"Many high-yield names are trading at levels that seem disconnected from the underlying credits," he said.

For example, Nguyen said corporate-backed municipals in the distressed energy and commodity sectors are at their richest levels in years versus their corporate counterparts.

That has helped price stability on the municipal side, he said.

"On the taxable side, many of the energy-related names are trading at depressed dollar price levels that reflect expectations for an eventual debt restructuring, yet on the muni side the same credits are still trading at a much higher dollar price," he said.

While rising interest rate fears do have a more direct impact on the municipal market, the Federal Reserve Board's quarter point increase after more than eight years of its zero-bound target was understated and showed little to any effect on the general or high-yield market. "That is not to suggest that it couldn't eventually have a big impact," Miller said, "but it doesn't appear to be having a big impact just yet."

The Fed's rate increase may even have been a catalyst of investment in the municipal high-yield asset class, according to Miller.

"I think people were waiting to get it over with to see what the impact would be – and there weren't any undue declines out there resulting from that," he said.

Investor concerns seem to be waning even in a sector that is heavily long-dated. "Although those fears are ever-present, I think they receded a bit, and that is one worry that is less pronounced," Miller said.

The opportunity to earn attractive average spreads of 250 basis points compared to the generic triple-A market helps offset the sectors' inherent risks.

Miller said there is value to be had in the health care sector where mergers and acquisitions have been strong and credit upgrades have been more frequent than downgrades lately.

For instance, nonrated bonds for New York's Albert Einstein Medical Center recently sold with a 5.50% coupon due in 2045 at par, and have traded up since the late January new issue, according to Miller.

In addition, the property tax-backed sector has seen steadily narrowing credit spreads – but yet is still attractive with some credits offering plus-240 basis points to the triple-A scale, down from as high as plus-275, Miller said.

"Underlying that is very steady property tax collections supporting these bonds and making them secure and reliable," he explained.

Nonrated bonds for the Crystal Crossing Metropolitan District in Colorado recently sold with a 5.25% coupon due in 2040 at par back in January and have also traded up in the secondary market due to the strong market conditions, Miller noted.

Meanwhile, the tobacco sector – a top-performer in the last two years — is also offering value due to some technical and fundamental catalysts, he said.

The sector has been supported by the steady inflows in 2014, 2015, and in 2016, according to Miller, as well as the combination of employment growth and falling oil and gas prices, which contributed to the stabilization and consumption.

He said they are a liquidity management tool that is sensitive to fund flows. "People buy them when they have inflows so they can sell them when they have outflows," he said.

The most actively-traded tobacco credits are California's Golden State Tobacco Securitization 5.75% coupons due in 2047, which is was trading at 6.08% yield on Wednesday. The bonds are rated B3 by Moody's Investors Service and B-minus by Standard & Poor's.

While these bonds represent the traditional municipal high-profile, the strong performing sector has gone through a bit of a recent transition, as "fallen angel" credits have arrived, expanding the scope and availability of high-yield options.

"While real-estate dependent sectors such as senior living and special assessment districts [dirt bonds] have rebounded along with the housing market, a new source of high-yield supply is coming from traditionally investment-grade sectors, specifically local governmental entities who have never fully recovered from the Great Recession, and are now struggling with the rising burden of unfunded pension liabilities," Nguyen said.

"School districts from Chicago to Detroit and Philadelphia are paying the price for years of structural deficits which are now brought to a head by budget shortfalls at the state level, and Illinois and Pennsylvania are prime examples of this," Nguyen continued.

While a lot of high-yield is new projects involving hospitals, schools, roads and bridges, it can also include "fallen angel" credits, so-called because of their recent decline from investment grade ratings due to serious fiscal distress and resulting credit turmoil, Miller said.

While many credits in Chicago remain investment-grade, Chicago general obligation bonds and Chicago Board of Education public school credits lost their investment-grade ratings last year amid the city's pension woes and severe credit deterioration and their own rocky finances.

Chicago carries a junk-level rating of Ba1 from Moody's Investors Service, and BBB-plus ratings from both Fitch Ratings and Standard & Poor's, with negative outlooks.

Spreads on a $500 million GO refunding and restructuring in January offered narrower spread penalties in its first GO deal since approving a large property tax hike.

However, its 2038 maturity with a 4.875% yield still offered 229 basis points over the triple-A benchmark when the deal was priced by Citi Jan. 12.

Even including these new troubled credits into the high-yield municipal universe Miller expects a forecast of lower default activity outside of Puerto Rico to be a supportive of the municipal high-yield sector going forward.

“In a low interest-rates world, an average of 250 basis points of excess return is pretty good, so I think the demand continues to be there,” he said.

“I think we can earn our coupon and plus perhaps a moderate amount of price appreciation if your credit selection pans out favorably,” he added.

The Bond Buyer

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