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Buy The Dip Becomes The Muni Mantra as Bonds Become Even Scarcer.

The “buy the dip” mentality has come to the municipal market.

With tax-exempt yields at the lowest in five decades and mutual funds receiving the most cash since 2010, investors are looking at any pullback as a chance to buy. That’s just what they’ve got: Benchmark 10-year yields climbed by about 0.06 percentage point in the past week since minutes from the Federal Reserve’s last meeting suggested that the central bank may be getting closer to another interest rate increase in the coming months.

“Any backup, we’d view as a buying opportunity,” said Sean Carney, head of muni strategy at BlackRock Inc., which oversees \$119 billion of state and local debt. “As long as demand remains as strong as it has been, it’s difficult to identify the catalyst that breaks the back of recent market performance.”



The increase probably won’t last long, even if the Fed raises short-term lending rates. On top of the billions of dollars pouring into muni mutual funds, about \$73 billion of state and local debt will mature in June and July combined, the most this year, data compiled by Bloomberg show. That adds buying pressure at a time when tax-free yields are historically low, yet cheap relative to global alternatives.

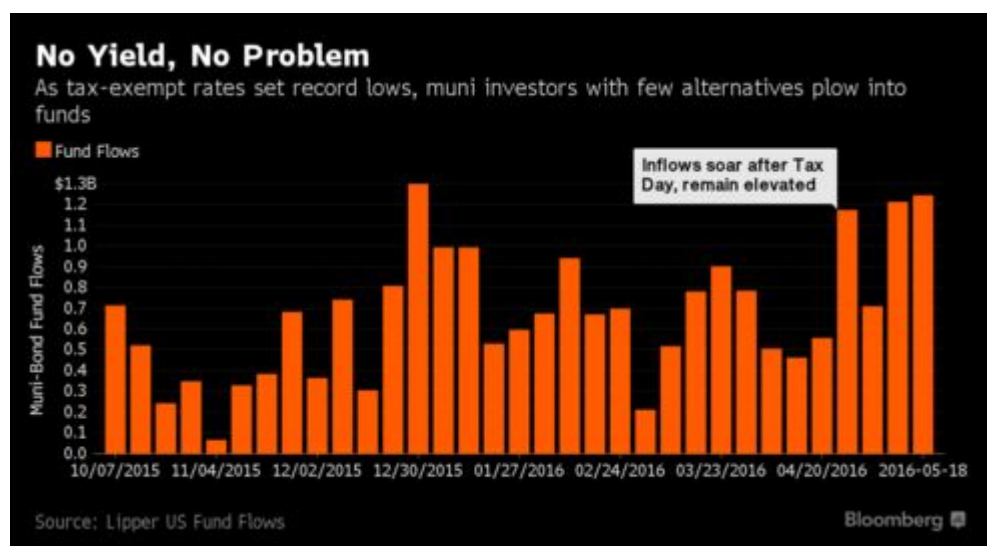
The \$3.7 trillion municipal-bond market has gained in each of the first four months this year, only the third time that’s happened since 1989, Bank of America Merrill Lynch data show. It’s up 0.4 percent in May, even as Treasuries and corporate debt have declined.



Even the tax-exempt market has weakened on the Fed officials' emphasis that they could raise their benchmark rate in June. The futures market is factoring in a 32 percent chance the U.S. central bank will raise rates next month, up from just 4 percent a week ago. Over that period, munis declined 0.2 percent.

Countering the effect of the Fed's minutes: Individuals poured \$1.25 billion into tax-exempt mutual funds in the week through May 18, the most this year, Lipper US Fund Flows data show. That extends the current streak of inflows to 33 weeks, the longest in six years.

In addition to the inflows, muni investors are poised to receive a wave of cash as their securities mature. About \$36.5 billion will come due in each of the next two months, and another \$31.5 billion will mature in August, data compiled by Bloomberg show. Many individuals hold the bonds until maturity for the tax-free income, meaning they'll use much of the principal payments to purchase new securities.



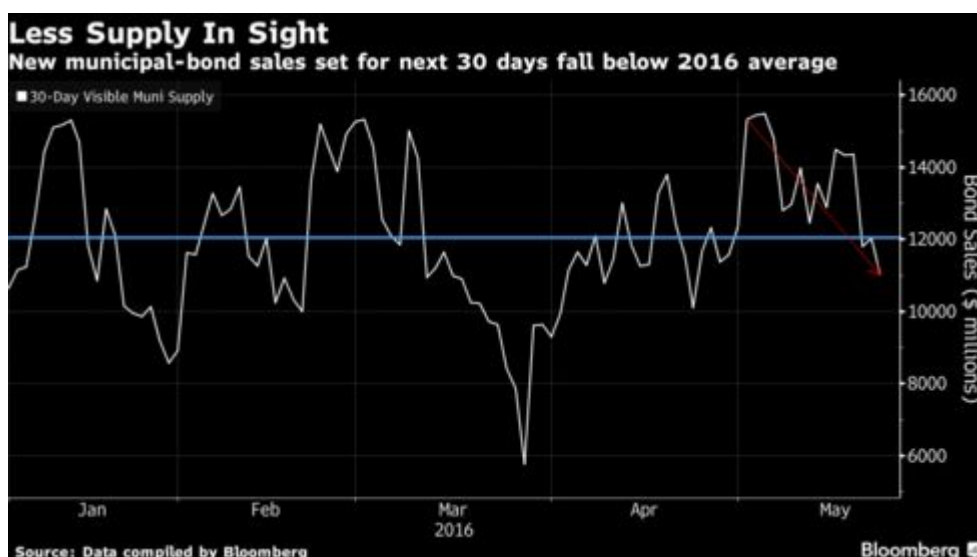
Others are newcomers — Asian and European investors who are buying U.S. state and local-government debt in the face of negative interest rates in their own countries.

"There's just been such rabid demand for munis this year," said Steve McLaughlin, a senior muni

portfolio manager focused on arbitrage trading at First Empire Securities in Chatham, New Jersey. When it comes to bond prices, “we’re at all-time highs, but we could shoot through that,” he said.

More investors are coming into the market looking for bonds just as fewer municipal issuers are selling them.

State and local governments have scheduled about \$11 billion of bond sales in the next 30 days, the smallest slate in a month, Bloomberg data show. While the figure tends to underestimate the amount of offerings because some are announced just days in advance, it serves as an indicator of what to expect.



Issuance tends to climb from May to June, explaining why munis have posted negative returns during the month in most of the past decade, BlackRock’s Carney said. The fact that the Fed is considering raising interest rates adds to the chance of losses in the weeks ahead, he said.

Though for any sellers out there, it appears there will be just as many buyers — if not more.

“These yields are low, but they certainly have the potential to go even lower as we head into June and July with a heavy calendar of maturing bonds and coupons,” said Phil Fischer, head of municipal research in New York at Bank of America Merrill Lynch. “Performance in munis has just been something to write home about.”

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