After Brexit Rally, Munis to See Low Yields, Strong Demand.

In one of the biggest rallies in recent memory, municipal bonds surged on Friday after Britain voted to leave the European Union.

Yields on some top-rated municipals fell as much as 17 basis points to record low levels. Analysts said the move signaled that yields will remain near all time lows longer than anyone had expected and that negative U.S. interest rates may be on the horizon.

A New York muni trader who has been in the business for over 25 years said that Friday was one of the wildest trading days that he had ever seen.

"The flight to quality was crazy overnight and muni ratios got ridiculous cheap," the trader said. "We pretty much had two types of buyers who came in and bought. We saw the mutual funds who were getting squeezed because they were getting higher coupons getting redeemed and taken out, which forced them to re-invest at lower yields. When they come in, they chase the market. But on top of that, we saw absolute low yields and attractive relative yields."

While analysts saw Friday's trading as just a one-day price movement, they also felt there were longer-term implications looming for the market.

"Today's rally is an overreaction, no doubt" said Vikram Rai, CFA and head of municipal strategy at Citi. "But there is no doubt that Brexit will mean lower yields for a longer time."

Rai said Federal Reserve Chair Janet Yellen is very cautious about roiling the financial markets by raising interest rates too early – and that she had waited and bypassed a chance for a June hike in order to study any possible effects of a Brexit yes vote.

Others also saw a cautious Fed ahead.

"With the news, it seems pretty likely you take the Fed off the table now," said Jim Grabovac, senior portfolio manager at McDonnell Investment Management.

"It is off the table for July [and] unlikely conditions would warrant actions prior to the end of the year," Grabovac said. "Aside from the near-term shock, over the medium-term I think this will put pressure on rates to remain low and will stay persistent. This could also be seen as a positive for the dollar, and a stronger dollar would pressure U.S. inflation higher."

Municipal Market Data's Senior Market Analyst Randy Smolik also said he that a July rate hike by the Fed was probably off the table, but that doesn't mean the Fed won't move later in the year.

"There's no immediate satisfaction," he said, noting that Britain has up to two years to negotiate a withdrawal from the EU and that a lot could change in that time.

On the buy side, sources stressed both the short- and long-term consequences to the Brexit vote.

“The immediate impact is lower yields and higher dollar prices on most high to medium-quality bonds,” said Michael Pietronico, chief executive officer at Miller Tabak Asset Management in New York City. “We sense 5% coupons will begin to lag as the ultra-high dollar prices will turn retail investors off.”

Pietronico said his firm has long held that negative interest rates were heading to the United States. “We have been vocal on that call for months with our target for this to occur in the second half of 2017,” he said. “If we are wrong on this call it will only be because it happens sooner.

“The United States economy cannot sustain growth with a strong U.S. dollar and the direct consequence of Brexit will be downward pressure on inflation here in America, and a Federal Reserve [that] will no longer even challenge the notion outwardly of raising rates again.”

According to Friday’s final read of Municipal Market Data’s triple-A scale, the yield on 10-year benchmark muni general obligation fell 17 basis points to 1.36% from 1.53% on Thursday, while the 30-year muni yield declined 15 basis points to 2.08% from 2.23%. Both maturities are now at record low levels. At one point during the day, yields were down by as much as 20 basis points.

Markit said the effects from Brexit vote were felt throughout the market early on Friday, with yields on investment-grade bonds tightening 17 to 20 basis points from previous day’s close.

According to Markit’s evaluated bond pricing service (http://www.markit.com/Product/Pricing-Dat--Bonds-Municipal), yields on University of California, 5’s of ’46, tightened by 18 basis points.

And the rally was not isolated to top rated-munis, Markit said, adding that yields on lower rated Loma Linda University Medical Center, 5.25’s of 56, tightening 14 basis points as well. Taxable California, 7.6’s of 40, also rallied 10 basis points from previous day’s levels.

Some analysts see a continued demand from buyers of municipal securities.

“The market for munis has been strong and this will only add to the dynamic,” said Dan Heckman, senior fixed-income strategist at U.S. Bank Wealth Management. “I am not surprised the vote went that way, but I was surprised by the margin of Exit; it was a wider win than I thought would occur. What is happening today is a unwinding on the equity side.”

Other market strategists agreed.

“I expect business as usual for munis after the dust of today’s rally settles,” Janney Municipal Strategist Alan Schankel said in an email on Friday. “As low as our rates look (munis and Treasuries), they are still above rates of Euro economies, some of which are negative (Switzerland and Germany).”

George Rusnak, Head of Global Fixed Income at Wells Fargo Wealth Management, saw a fair amount of trading volatility but said that was “both exacerbated and muted by this being a Friday in summertime,” when there is typically less trading being done.

He said he was not seeing the market have any liquidity problems, but added there was a bifurcation in munis, with some buyers gravitating toward a risk off trade while other looking moving into it as a risk on trade.

Munis have done very well so far this year, he said, in terms of mutual bond fund inflows and muni to Treasury ratios.

He said the only fly in the ointment might be that low yields are forcing higher pricing and that issuers might have to change their focus.

“They are running into retail resistance,” he said, adding that there’s a recalibration taking in mindsets, so there may be more issues being priced with lower than 5% coupons.

But most saw strength in munis lasting beyond the day.

“We have lower yields now, but munis are hanging in there,” said Dawn Mangerson, senior portfolio manager at McDonnell Investment Management. “I would say hold onto your munis for a little longer, they are a safe haven and a complement to equities.”

She added that “positive yield is awesome for foreign investors.”

Other analysts agreed.

While there is likely to be global economic uncertainty and global financial-market volatility, Peter Donisanu, global research analyst, and Paul Christopher, head global market strategist at Wells Fargo Investment Institute believe that the domestic impact will be manageable and investors should remain active.

“Outside of limited trade ties, the direct impact around the world is likely to be contained, and we believe that growth in the U.S. economy may slow from 1.9% to 1.7% in 2016,” the team wrote in a June 24 global investment strategy report.

“Systemic risks are likely to remain subdued given significant financial tools available to central bankers and the significant amount of global liquidity available,” the analysts wrote. “We believe that it is important that investors look through the uncertainties related to UK’s upcoming negotiations with the EU and remain fully committed and fully invested in their long-term investment plan,” Donisanu and Christopher added.

There are longer-term effects of the Brexit referendum that should be taken into account as well, strategists said.

Rai saw three possible scenarios. Politically the vote could embolden some political parties in other EU counties to also push for a membership referendum. Economically, the impact could result in slower growth in the Eurozone, he said. Slower growth means lower yields, he said, and that could be good for U.S. Treasuries. Financially, it may mean many banks which had moved headquarters to London may move back to the continent, which might hurt bank profitability.

Heckman also saw a possible political danger

“On the long term, if other countries want to make votes to leave the EU, that would be problematic and create volatility,” said Heckman.

The Brexit vote should bolster and support municipal bond prices, especially with a favorable July and August seasonal period on tap, while the long term implications of the British exit from the EU will take time to evaluate, according to Anthony Valeri of LPL Financial.

“The negative economic implications and lingering uncertainty are positive for municipal prices,” Valeri told The Bond Buyer Friday afternoon. “As is typical during flight-to-safety rallies, munis lag Treasuries but are still enjoying broad-based strength — long-term bonds outperforming intermediate, which in turn is outperforming short-term bonds.”

“Despite a strong start to 2016, I don’t envision recent gains fading soon,” Valeri said.

Overall, Valeri said Brexit should reinforce investor demand for high-quality bonds, however, while a flight-to-safety is underway, he said municipals are unlikely to match the pace of Treasury gains. In addition, he said, central banks are now more bond friendly and the Federal Reserve rate hikes before end of year are highly unlikely.

The Bond Buyer

By Chip Barnett and Aaron Weitzman

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Christine Albano contributed to this story.

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