Bond Case Briefs

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Pithy Maxims That Govern The Municipal Bond Market.

If you're an investor that follows the stock or bond markets with any diligence, you've surely come across some headline with a dire prediction screaming something like "stock valuations are just like before the crash of 1929!" or similar such parallels. It grabs us because it preys on the intrinsic fear of uncertainty that all investors face. Cognitively, we know it is hyperbole, but emotionally we feel a little bit of nervous twinge because, well, who knows? This time they just might be right. After all, isn't there a pithy maxim that tells us that "those who do not remember the past are condemned to repeat it?"

This year, the headlines for municipal bonds are anything but dire. In fact, it's been quite the opposite–everyone is predicting a great year for munis. The market is up around 4.50% year-to-date (source: Barclays Municipal Bond Index). Intermediate and long municipal bond rates are now at multi-generational lows. Thomson Reuters' bellwether Municipal Market Data ("MMD") benchmark curve has the 10-year and 30-year AAA yields hovering in the 1.40% and 2.15% range, respectively.

Municipalities and public authorities alike are taking advantage of the low interest rate environment to refund their higher yielding debt. As data from The Bond Buyer shows, there are more refundings than there are bonds issued for new projects. Investors getting their money back from refunded bonds are finding fewer bonds to reinvest in. This supply-demand imbalance is further fueling the market's gains.

The rising tide is lifting all boats. Mutual funds are prospering, finding their assets under management up by more than $50 billion, enjoying 11 uninterrupted months of positive flows since October 2015 (source: Investment Company Institute). Municipal ETFs have enjoyed similar positive flows during the same period, netting $5.7 billion. Money is also flowing into separately managed accounts. Cerulli Associates reported that flows into municipal SMAs were up 33.9% in 2015. With no signs of these SMA flows abating, 2016 could well become the fifth consecutive year of asset growth nearly making or exceeding 30%. By that estimate, the top SMA tax-exempt bond managers could see upwards of $45 billion added to their AUM by year end.

There are even flows coming into the market from so-called 'non-traditional' buyers. Given negative rates in Europe, foreign buyers are putting money to work in municipals so as to enjoy the positive risk adjusted rates. It's unclear what the split is between taxable and tax-exempt buy-in from the internationals, but there is 100% agreement that it's coming in.

Not only are rates lower, credit spreads are tighter. The spread in yield between AAA general obligation bonds and A hospital bonds is about 57 basis points. At the start of 2014, the spread was 125 (source: MMD Thomson Reuters). It seems that, with all that money to put to work, investors are more open-minded about expanding their credit parameters.

I hate to be a 'Debbie Downer' in the midst of all this ebullience, but I have in mind another pithy maxim, this one from Shakespeare: "What's past is prologue" (The Tempest, Act 2, Scene 1). When these conditions occurred previously—the large flows, the non-traditional buyers, the eschewing of credit standards—it never ended well, as is detailed below and in the charts.

An event occurs, usually tied to rates, which suddenly changes everyone's perspective. Money starts flowing out as fast as it flowed in. The non-traditional buyer who had been taking advantage of the arbitrage, gets jittery or finds better opportunities in other markets. The individual investor usually just panics and sells. As investors large and small rush to the exit en masse, they quickly discover the persistent liquidity problem the municipal bond market has when faced with large outflows. Prices back-up fast in a volatile reaction.

The past here is really not that far in the past and the parallels are striking. Think back to the time period from September 2011 to the end of 2012. For 15 consecutive months, mutual fund investors poured in nearly $65 billion into the market. The trend culminated in January 2013 when investors bought an astonishing $7.1 billion of municipal bond mutual fund shares. It was the largest single month of inflows since September 2009 and would prove to be the third largest inflow over the last ten years.

Then in May 2013, Federal Reserve Chairman Ben Bernanke made what he thought was a fairly innocuous announcement regarding tapering off the Fed's quantitative easing program. Fearing rates were about to rise, nothing short of panic ensued. Over the next few weeks, investors pulled out nearly $65 billion from the market (see When Bonds Turn Negative, Keep Your Perspective). Outflows exceeded both the Credit Crisis of 2008 and the Meredith Whitney-caused blow-out in 2011—two other recent examples when the market lost its collective reason.

The whole episode was later given the cutesy moniker of "Taper Tantrum" but it was anything but cutesy. In a few short weeks, investors lost billions of dollars of net worth in their municipal bond holdings. From the beginning of May 2013 to mid-September. Thomson Reuters' MMD AAA 10 year yield spiked from 1.66% to over 2.80%—a nearly 115 basis point give up. The 30 year AAA yield rose from 2.79% to just shy of 4.40% over the same time, a 160 basis point roll-back.

Look, I know it's not 2013 all over again. Yes, the parallels are there, but the circumstances are different, the facts are different, the markets are different—there are a host of reasons things aren't 'just like' the prior period of disaster. Recall that other pithy maxim: "predictions are difficult—particularly about the future?"

Yet something lingers in the back of my mind. The particulars today may indeed be very different, the circumstances completely divergent—but the market's reaction to a trigger event that precedes a crisis hasn't changed. We don't forget history, but we don't necessarily learn from it either. In the heat of the moment, people are still people and people will still panic and act irrationally. An event will occur and, if history is any guide, it won't be one anyone is anticipating. Today's bull market in municipals will face a crisis in the months ahead. Flows will reverse and the exits will clog. When that happens, as the nearly ubiquitous saying these days goes, "Keep calm and carry on."

Barron's

Sep 7, 2016

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