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Why Muni Experts Need a New Crystal Ball.

Looking back, municipal experts compared the tax-exempt bond market in 2016 to a white-knuckle thrill ride – without seat belts.

“I would describe 2016 as a ride on a roller coaster – there were some wonderful highs and some very painful lows,” Dan Heckman, senior fixed income strategist at U.S. Bank Wealth Management, said in an interview on Thursday.

Tax-exempt professionals were caught off guard by three events in 2016: the consecutive inflows into municipal bond mutual funds, the spike in volume, and the selloff following the presidential election.

They were otherwise largely on target with most of their other expectations about the economy, demand, and credit spreads just as 2016 was getting under way a year ago. In retrospect, though, they said they couldn’t have predicted the volatility that surfaced by year end.

“The market initially expected at the start of 2016 that bond rates were likely to move higher in line with the Fed’s expectation for better U.S. growth,” Rich Ciccarone, president and chief executive officer of Merritt Research Services LLC, said in an interview on Wednesday.

“That trajectory was derailed just weeks later as evidence of subdued global prospects and weak oil prices appeared to suggest an unforeseen negative correction,” he said. “Bond rates fell and the stock market subsequently languished for much of the year as low inflation expectations, oil, Brexit and politics provided fertile ground for volatility and being defensive.”

Heckman said the market saw its share of major ups and downs along the way, starting with a dismal forecast.

“The market set up not to do that well after two previous strong performance years in 2015 and 2014,” Heckman said. However, the market “took a strong bid and saw lower interest rates from February through June.”

Many of the surprising events took place in the second half of the year, Heckman said.

“In July the market saw signs of weakening, and stayed weak as we went through September, October, and through November,” he said. “In November, the market got sold off and the severity of it took us all by surprise,” before rebounding in December, Heckman said.

Municipals were flat and total returns were zero heading into year-end as the post-election dip erased earlier gains.

Some analysts were on the right track when it came to their general predictions, but admitted they were off when it came to volume and the impact of the election.

“With the benefit of hindsight, as the year unfolded it largely went in the direction we thought it would, but we certainly didn't anticipate it would take the roller coaster ride it did," said Jim Grabovac, who co-manages portfolios with Dawn Mangerson at McDonnell Investment Management.

He was referring to the plunge in municipals following Donald Trump's victory in the Nov. 8 presidential election.

"Our fundamental outlook worked very well for us, but we certainly did not anticipate those deviations on the political front that took place" in the fourth quarter, Grabovac said in an interview on Tuesday.

Muni yields, which move inversely to price, surged on concern that Trump's victory in the presidential race and Republican control of the House and Senate would open the way to tax reforms that dissipate the value of – or eliminate – the bonds' tax exemption.

Muni yields rose by as much as 55 basis points a week after the election amid uncertainty over government spending and inflation, including a one-day jump in yields by 22 basis points in a single trading session on Nov. 14.

"We turned bullish on the market because we thought things had gotten very extreme," Heckman said. "Yields had gotten too high and prices too low" over concerns of personal income tax reform under the Trump administration as well as the expectations of the Fed's December rate hike and prospects for ratcheting up the pace of tightening with further increases in 2017.

The S&P Municipal Bond Index finished down 3.46% in November, the worst monthly total return since September 2008, according to S&P Dow Jones Indices.

"What I didn't predict was the big sell-off in the Treasury market," Heckman said. "People were positioned for rates to drop" under a Trump victory, but instead, the opposite occurred, he said.

Further significant market impact after the election surfaced when municipal mutual funds reported the biggest outflow in more than three years as investors withdrew $3.011 billion out of the industry in the week ended Nov. 16. That came on the heels of $62.837 million of inflows in the previous week.

Some of the unexpected activity arrived in the first half of the year – well before the election and the market sell-off.

"The number one surprise for everyone was the consecutive flows into muni bond funds," Heckman said. "It ran much longer than we anticipated and that consecutive streak set a record," he said of the 54 consecutive weeks of inflows into municipal bond mutual funds.

That streak came to a close in the week ended Oct. 19 when $135.9 million fled the industry for the first time in over a year. It was the second longest stretch after weekly reporters saw 63 weeks of consecutive inflows back in 2010.

Meanwhile, Heckman was among those market participants that were off target with their predictions for volume – which turned out to be larger than he and others estimated. He assumed supply would total just over $400 million — but his guess was well under where it ended at approximately $446 billion.

Due to concerns over the Fed's rate policy, issuers raced to market to get deals done – particularly between September and November, Heckman noted.

“The issuance total for 2016 took us a little off guard – it was larger than we expected and also broke a record set back in 2010,” he said.

As a result, Heckman expects issuance to taper off in early 2017 given the late 2016 flurry.

The McDonnell team anticipated 2016 supply would be closer to the $375 billion total of 2015. However, lower interest rates after the British vote to leave the European Union helped swell refunding issuance, which drove the record municipal volume in 2016, Grabovac said.

Like Heckman, the McDonnell team didn’t foresee the potential for interest rates to rise in 2016 as significantly and substantially beyond the general level the market had seen in the last few years, Grabovac said. That volatility was politically driven and changed the rate scenario dramatically through the year.

“It drove rates lower than they should have, and then the reaction to the election took them higher than we warranted,” Grabovac said.

In addition, he and Mangerson were surprised by the fluctuation in municipal valuations compared with their expectations for valuations to remain relatively stable over the year.

In late November, ratios of triple-A municipals to Treasuries soared above 100% from 10 through 30 years, according to Municipal Market Data.

“Because of the big increase in supply last year, munis underperformed Treasuries,” Grabovac said. Ratios of municipal yields to Treasury yields spent most of 2016 at 100%, after hovering at 85% in the 10-year range heading into the year.

“It was a reflection of higher-than-anticipated new-issue supply, and as a consequence, munis underperformed and valuations cheapened relative to Treasuries,” he said.

So far early in 2017, there has been a decent amount of supply and demand has strengthened following the November market sell-off, Mangerson said.

“As we enter 2017, munis remain attractive relative to Treasuries,” Grabovac said, adding that ratios across the yield curve are currently hovering around 90%.

“Right now, if we continue to see strong demand, valuations are likely to richen up from here,” Mangerson said.

She said overall the team’s fundamental outlook panned out in the end, but there was a little more volatility than they expected.

Aside from the effects of the political storm, Grabovac and Mangerson were close to their target predictions. McDonnell oversees $11.5 billion in client assets, 63% of which are tax-exempt municipal assets, including separately-managed accounts and two sub-advised municipal mutual funds.

The team anticipated that economic expansion would continue in 2016, although it ended up growing slower than they anticipated last year, Grabovac said.

“We thought inflation was well contained and in the process of drifting back toward the Fed’s 2% goal – and we believe the same in 2017 – largely driven by shelter cost and medical care inflation,” he explained.

They also predicted the Federal Reserve Board would continue to normalize rates at a gradual pace.

They believed the Fed would continue to raise short-term interest rates, but felt it penciled in too aggressive a rate path in the beginning of 2016. The Fed at that time had announced its plans for three rate hikes in 2016 – yet only accomplished one by yearend.

“Going forward we continue to think the rate path will be more gradual than the Fed’s summary of economic projections,” Grabovac said.

The firm’s other predictions – such as increasing exposure to spread sectors, such as hospitals, transportation, and power — worked in its favor.

“We thought the credit fundamentals were still solid and we felt comfortable going into sectors that offered more yield, but are historically more volatile,” Mangerson said.

The strategy allowed more yield into the portfolios from the hospital sector, for instance, where there was healthy issuance and attractive yields versus the plain-vanilla state general obligation sector — which underperformed for the year, Ms. Mangerson explained.

“Anything with yield performed better,” she said, noting that single-A and triple-B paper outperformed higher-quality paper in 2016.

For example, an A-rated hospital versus an A-rated GO – both due in 10 years – offered a 50 basis points yield pick up as spreads widened toward the end of the year, after compressing in the first two quarters, she added.

“Overall, the compression over the year helped performance,” as did the firm’s prediction that lower-quality sectors would outperform in a low rate environment with investors reaching for yield.

Heckman was more cautious and avoided some of the riskier outliers as he predicted some continued credit turmoil in 2016.

“I think we continued to be negative on Chicago, Illinois, and many of the states in the Northeast Corridor as we continued to see credit downgrade actions,” he said. “I believe we were spot on in 2016, and those things did occur,” he said.

He said troubled credits will gather more spotlight in 2017 – especially state pension funds will continue to raise a red flag due to liabilities growing faster than assets.

“We see that getting worse over the next few years if they are not addressed,” Heckman said.

Meanwhile, analysts, like Ciccarone, said years like 2016 are an example of why investor’s should always expect the unexpected.

“Economic and bond rate forecasts proved once again how difficult it is to confidently foresee the future when there are so many moving pieces that don’t always play out as expected,” Ciccarone said.

The Bond Buyer

By Christine Albano

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