[Bond Case Briefs]

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How Will the Bond Market Hold Up Against the One-Two Punch of Irma and Harvey?

Investors are wondering how the bond market will handle the one-two punch of Hurricane Harvey and Hurricane Irma.

Some market participants expect the economic impact of the devastation to take a third Federal Reserve rate increase off the table for this year by slowing down the pace of inflation. Others have argued credits for municipalities hurt by the hurricanes may suffer a drop in their ratings, or at least a perceived drop in their ability to pay their debts.

See: Here's what history says about Hurricane Irma and the stock market

To answer the question, John Mousseau of Cumberland Advisors and his colleague Gabriel Hament tested how bond yields reacted in the wake of hurricanes over the past 30 years. To do this, they tracked the 12 most destructive storms during that stretch and tracked how the U.S. 10-year Treasury note yield TMUBMUSD10Y, +0.76% and the Moody's municipal bond yield, a gauge of the average yield for high-grade municipal bonds, changed after landfall.

They acknowledged that their experiment could prove flawed if only because the strength of Harvey and Irma are expected to surpass the strength and ensuing destruction wrought from previous hurricanes.

The pair of bond investors found that the data was more mixed and less conclusive than they had expected, even if the general trend suggested bond markets tended to experience a yield rise, meaning a fall in bond prices, more often than not six months after a hurricane (see table below).

Six months after a hurricane, long-dated Treasury yields increase even as municipal bond yields show little change

Treasurys felt the bigger blow with the 10-year benchmark Treasury yield rising more than 13 basis points after a hurricane. Kotok and Hament think this "points to overall better insurance coverage as well as quicker response by federal agencies with relief dollars. This response translates, of course, into a higher level of economic activity in the years after a storm, and the bond markets perceive a potentially higher level of inflation."

The impact for municipal credits, however, was more muted as changes in muni yields have to be adjusted for their tax-exempt status. In effect, a move in municipal bonds is more pronounced relative to a move in Treasurys. But even after six months, the hurricanes barely moved the needle for municipal credits, in part because hard-hit areas make an eventual recovery.

Kotok and Hament's overall findings jibe with New York Fed President William Dudley's point that hurricanes "unfortunately" lifted economic activity through rebuilding efforts. But other economists have suggested the actual impact wouldn’t show up in gross domestic product figures, with the real blow being dealt to levels of household wealth in affected areas.

See: Fed’s Dudley says hurricanes Harvey, Irma to give boost to U.S. economy

For example, Mark Vitner, senior economist at Wells Fargo, told MarketWatch a week ago that flooded automobiles after Hurricane Harvey would need to be replaced, putting Texans in a worse position overall. “When they buy a new [car] that shows up as stronger GDP and the person feels better. But the stock of wealth is not better. We destroyed a car,” he said.

MarketWatch

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