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Muni Bonds Look Good Despite Annual Autumn Slump.

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- **The market has benefited from a reduced supply of bonds, largely as a result of tax reform passed last year.**
- **In high-tax states such as California and New York, the new $10,000 cap on the deductibility of state and local taxes has sent demand for tax-free muni-bond income soaring.**

It's that time of year again for the municipal bond market.

The fall months are typically weak for muni bonds and although this year has generally bucked seasonal trends, it looks that way again this year.

"There's been a lot of unevenness in a usually more predictable market," said Peter Hayes, head of the Municipal Bonds Group at BlackRock. "However, October tends to be weak so we were cautious coming into September."

True to form, muni bonds have been sliding. The Bloomberg Barclays Municipal Bond Index is down 1.43 percent since the end of August and now has a return of -1.11 percent for the year. That won't help send your kids to college, but relatively speaking, it's a pleasant surprise in an otherwise rough year for bond investors.

"Muni performance has been nothing to write home about, but it's been better than just about every other fixed income segment," said Tom Hession, managing partner at Riverbend Capital Advisors. Hession's firm sub-advises separately managed accounts of muni bonds for wealthy clients.

In the rising interest rate environment, the muni index decline compares very well with U.S. Treasury bonds -2.12 percent and U.S. investment grade corporate bonds -3.1 percent, through Oct. 16. "Munis tend to do relatively well in a rising rate environment," said Hayes, who credits their higher coupons and callability for insulating against rate increases. "They outperform when rates are rising and underperform when rates are falling."

The current weakness, however, could extend for a while if interest rates resume their rise and market supply and demand factors become more negative.

So far this year, the market has benefited from a reduced supply of bonds, in large part, as a result of tax reform passed last year. Because of uncertainty over the tax-exempt status of muni bond income, as well as other potential rule changes in the market, issuers flooded the markets with bonds at the end of last year, pulling roughly $30 billion of issuance forward, according to analysts.

That led to one of the worst Januaries for the muni market on record (-1.18 percent). But it also cleared a lot of bonds from the pipeline that would have otherwise hit the market through this year.

The tax bill also disallowed the common practice of advance refunding, which enabled municipalities to refinance debt at lower rates. It accounted for about 15 percent of muni bond issuance in the market.

“The low supply of bonds has definitely helped the market this year,” said Brian Nick, chief investment strategist at Nuveen.

The current expectation that issuance is picking up, however, is now hurting it. With interest rates trending up, issuers may want to come to market before they rise much further. “We think supply will track up, but not as dramatically as it did at the end of last year,” said Hayes.

On the demand side of the equation, the uncertainty over tax reform appears essentially resolved. The demand for munis from the institutional side of the market — about 30 percent of the total — has fallen. The lowering of the corporate tax rate to 21 percent from 35 percent has reduced demand for tax-free income at banks and insurance companies, but the market has now largely adjusted, according to Hayes. “The insurance companies have done their reallocations,” he said. “Most of the selling occurred in the early part of the year and we haven’t seen much in the last few months.”

The lowering of marginal income tax rates also makes tax-free income relatively less valuable for individuals. However, the changes on individual rates are far smaller than on the corporate side and individuals continue to look to muni bonds for income.

Other tax rule changes may actually have boosted overall demand for tax-exempt income. In high-tax states such as California and New York, the new $10,000 cap on the deductibility of state and local taxes has sent demand for tax-free muni bond income soaring. The spreads on AA-rated California bonds with AAA muni bonds and U.S. Treasurys have fallen dramatically this year. “I think the tax bill was a net positive for the market,” suggested Nick. “Many other ways to avoid taxes were stripped away, so demand for tax-free income is now higher.”

The fundamentals underlying muni credit profiles are also improving thanks to the strong economy. Personal income tax revenues and property taxes are up 5 percent and 6.5 percent in the last year, according to Hession. Muni defaults have totaled less than $2 billion so far this year, with virtually all of that related to FirstEnergy Solutions, a power generating business of the Ohio-based utility that declared bankruptcy earlier this year.

“Muni issuers tightened their belts after 2008 and economic growth is now benefiting state and local governments,” said Hession. “The outlook for muni credit looks like it will stay positive for the foreseeable future.”

The more than $16 billion of asset flows into muni bond funds this year suggests retail investors are still keen on the market. Those flows, however, have recently hit a wall, with investors pulling a net $3 million from muni funds in September. Flows could fall further, said Hayes. “When the market turns negative, demand from retail investors often declines,” he said. “It will be interesting to see if that happens this time.”

Hayes thinks that the combination of higher rates and increasing supply of bonds could push yields higher by another 10 to 20 basis points, but he’ll be ready to lock in rates if that happens. With the muni duration curve much steeper than the Treasury curve, he currently favors a barbell investing strategy. He invests in 20-year-plus munis that are paying a significantly higher yield, and very short-term bonds of less than two years that he can rapidly redeploy at higher rates down the road. “The relative value on the front end of the curve is expensive and on the long end it’s cheap,” said

Hayes.

With interest rates rising and worries about more supply of bonds coming to market, it could be a volatile finish to the year.

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by Andrew Osterland

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