Municipal Comment

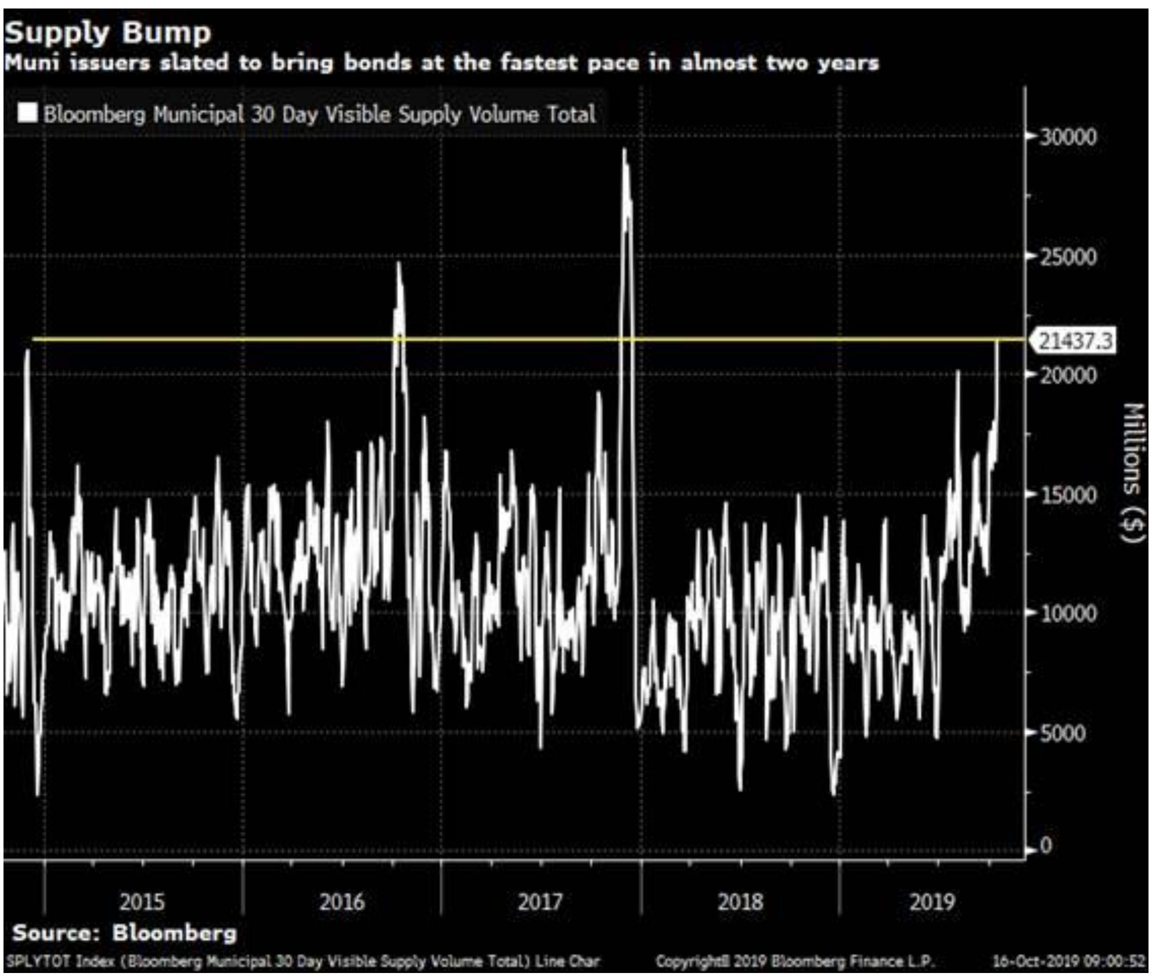
October 2019

Near Term

While the municipal bond market has experienced strong performance in 2019 with the Bloomberg Barclays Muni Index up 6.75% through September 30th, the balance of the year may be a bit choppy. Historically munis have struggled in the 4th quarter. Since 2009 average 4Q muni returns have averaged -0.05% while annual returns over the same period have averaged nearly 5.00%. Historical dynamic is no guarantee of future results, but this has been the trend in seven of the last ten years. An uptick in volatility and interim weakness may present opportunities.

Heavy new state and local government issuance, municipal bond mutual fund outflows, geopolitical events, and trade policy uncertainty could contribute to 4th quarter volatility. On the flip side, a slowing economy, accommodative monetary policy, soak the rich rhetoric and proposals being discussed in political debates and robust demand for munis in the aftermath of tax reform are longer-term positives for muni performance.

In terms of market technicals, year-to-date new issue muni supply is approximately 10% higher versus the same time period last year. Anticipated new issue volume as measured by Bloomberg 30 Day Visible Supply is at the highest level in two years. Heavy 4Q issuance is not unusual as state and local governments bring deals to market before year-end. Given the current rate environment, this is likely to be the case in the coming weeks.



Follow the Money

Municipal bond mutual funds have experienced the heaviest inflows in 27 years with an estimated $70 billion added so far in 2019, according to ICI data. This included a 36 consecutive week run of positive flows, which ended in September. Individuals own $640 billion in munis via separately managed accounts, an increase of 6.25% vs. 2018. Banks have decreased holdings by $50 billion and insurance company holdings have been largely unchanged.

Credit Positive

Municipalities are generally well-prepared for an eventual economic downturn, should the credit cycle move negatively. According to the Bureau of Labor Statistics, first half of 2019 tax receipts for state and local governments have increased 18% year over year. For the most part, government officials have been responsible and disciplined in managing these surging revenues, adding to reserve funds to cushion budgets for future fiscal challenges. On average, state rainy day funds currently represent 7% of annual spending vs. 2.00% post financial crisis. Rating upgrades have outpaced downgrades in 2019 by approximately two to one.

Why Munis?

For many investors, the objectives of a municipal bond allocation include capital preservation, generation of tax-free income, and balance of risk with more adventurous investments. Municipal bonds tend to not experience the same degree of price fluctuation as US Treasuries, non-U.S. sovereign debt and corporate fixed income. Default rates are low. Income is predicable. We prefer intermediate duration, higher quality credit, premium coupon bonds as we believe this structure is defensive yet offers attractive taxable equivalent yields and takes advantage of higher muni ratios to UST's in this range.

Please feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

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