Market Comment 2/24/14

Review

As the municipal bond market marches forward in 2014, it may be helpful to consider the developments of the last several months in order to gain a perspective on how we arrived at this point. A year ago we were looking at yields hovering near all-time lows, tight credit spreads, and a market trading rich on a ratio basis. Overall, it was an environment with little room for error. At the outset it seemed that 2013 was going to be all about interest rate concerns. Things got interesting in May when Fed tapering discussion surprised the market. Muni yields followed US Treasuries in their rapid ascent. Within a couple of weeks, the Detroit bankruptcy exacerbated the situation for munis. Outflows from muni bond funds had already commenced, but the Detroit announcement fueled the fire. The muni selloff intensified as Detroit-related media reports grabbed daily headlines. Individual investors represent a significant proportion of muni bond holders at nearly 70%. They tend to inflate gains and losses in times of market volatility. The muni curve steepened rapidly and yields rose nearly 100 basis points in a matter of weeks late during 2Q.

Muni funds were forced to contend with record outflows. Of the approximately $500 billion in fund assets, massive 2013 redemptions were in excess of $60 billion – nearly four times the amount of all previous fund outflows combined. Emotional retail muni fund investors reacted with panic to initially small negative returns, and the selling frenzy followed. To make matters worse, a late summer Barron’s article highlighting the fiscal woes of Puerto Rico drew attention to another unique yet problematic situation. Not unlike Detroit, Puerto Rico’s economic deterioration had been years in the making. However, Puerto’s Rico’s $70 billion in bonds outstanding (vs. Detroit’s less than $1 billion) was more problematic given that the bonds were so widely held. More than three quarters of muni funds owned Puerto Rico debt, and for many it represented a very significant percentage of holdings. Negative bond fund performance tends to lead to outflows, and the spiral continued. As is often the case in the muni market, overreaction to idiosyncratic developments tends to create opportunity. By the fall, the impact of the Detroit and Puerto Rico situations was a market that had become quite attractive on a tax-adjusted basis. Munis were cheap to UST’s and other credit alternatives, providing a cushion against possible increases in rates. Credit spreads widened, offering potential additional protection.

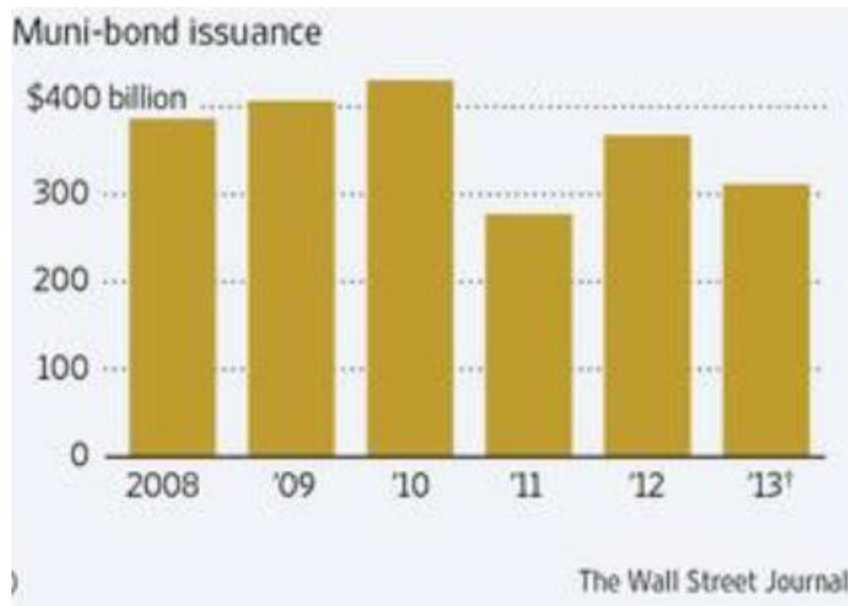
Credit Quality: The Bad News and the Good News

On the negative side, within the last couple of weeks, all three major credit rating agencies downgraded Puerto Rico's debt to junk status. Puerto Rico's approximately $70 billion in bonds outstanding is an amount approaching the size of its entire economy. It's debt to GDP ratio is 84%, and if its $30 billion in unfunded pension liability is factored in, the ratio is 140%. The island has been in recession for ten years and its economy continues to weaken. The official unemployment rate is nearly 15% and the crime rate is staggering. Puerto Rico's poverty rate is 45% and its population of 3.6 million is trending lower as citizens leave the island in search of work. While the governor and current administration are making a valiant effort to balance the budget and grow the economy, the situation seems extremely challenging at best.

San Juan, Puerto Rico

As the island's fiscal woes came into the spotlight last year, yields on longer term Puerto Rico bonds nearly doubled, approaching 10% on some issues. At one point, the price of Puerto Rico debt dropped as much as 40%. The situation has been particularly negative for many muni bond fund holders, as most of Puerto Rico debt is owned by funds. Over the years, the unique triple tax-exempt (federal, state, local) feature of Puerto Rico bonds has made them popular with bond funds. In 2013 many investors were surprised to learn the magnitude of Puerto Rico bonds held by muni funds. Transparency is one of the potential benefits of owning individual issues rather than a fund. For example, at Riverbend Capital we have consistently avoided Puerto Rico issues in client portfolios over the years.

Away from the dire situation in Puerto Rico, state and local municipal credit fundamentals have demonstrated resiliency and have continued to improve. Over the last few years, states and municipalities have made cuts, controlled spending, raised taxes, instituted public employee pension reforms and limited benefits. State payrolls are at 2004 levels. Housing markets have stabilized in a positive development for property taxes. After 16 straight quarters of growth in state tax receipts, many states now have budget surpluses.



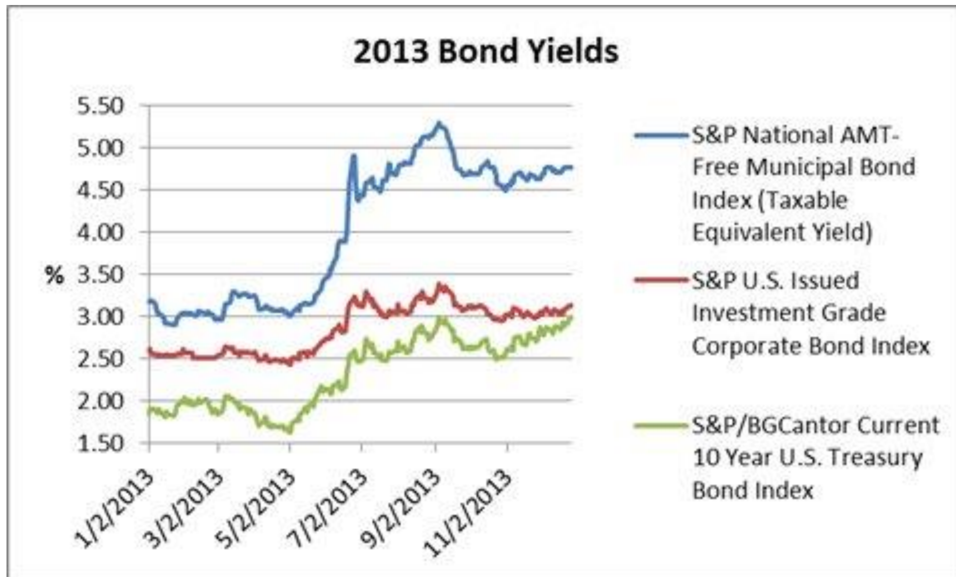
While there are certainly ongoing fiscal challenges for bond issuers, the situations in Detroit and Puerto are not systemic – despite media hysteria to the contrary. They were slow moving train wreck's that finally caught the attention of the public after many years of warning. Municipal default rates have remained extremely low, 0.03% over the last five years for Moody's rated issues. Credit is stronger and accordingly there has been less need for states and municipalities to issue bonds for the funding of capital expenditures.

The Benefits

The tax-free aspect of muni income increases in value as tax rates move higher. After tax rates ratcheted up in 2013, the tax-exemption is currently the most valuable it's been in 30 years, . The top tax rate moved from 35% to 39.6% last year. The new 3.8% Medicare surtax now applies to most forms of investment income, but not to municipal bond interest.

A muni bond yield of 3% in 2012 had a taxable equivalent of 4.62% for investors in the then highest bracket 35%. In 2013 taxable equivalent yield on the same bond would be 5.30% at the new highest rate 43.4% (including Medicare surtax), and even more significant for investors in high tax states. As investors complete their tax returns over the coming weeks, the impact of these tax increases will be felt and may result in heightened interest in tax-free bonds.

In addition to their tax-advantage, municipal bonds continue to offer safety, diversification and steady income. The muni market as represented by the Barclays muni index has produced negative returns in only six of the last 33 years and default rates remain extremely low. That being said, isolated yet high profile credit problems can fuel negative perceptions and cause volatility. Interest rate risk continues to be a concern as well. As rates rise, many longer duration, low coupon bonds are especially vulnerable. The first 100 basis points of rate increase is likely to be the most painful for holders of this structure as the bonds fall out of de minimis range.



2013 bond yields - S&P Dow Jones Indices

Looking Forward

We will continue to monitor UST rates, mutual fund flows, and muni headline risk vs. intrinsic value in the market. While it's impossible to accurately predict the direction and degree of future interest rate moves, we believe the best option is continue to position portfolios defensively and try to take advantage of periods of weakness caused by credit concerns or spikes in yields. While muni fund outflows have tapered off over the last several weeks, modest rate increases leading to small negative returns for muni funds tend to be amplified by retail investor selling, which may create opportunity in 2014. Gross supply of municipal bonds is expected to be flat to down slightly this year. Large amounts of calls and maturities will offset a slight increase in new issuance. And it is important to keep in mind that while the plight of both Detroit and Puerto Rico are both unfortunate and noteworthy, they are unique situations and not representative of the typical American state or municipality. In fact, there has been a broad improvement in muni market credit fundamentals that we expect will continue.

Cash doesn't pay in this environment. And for investors with a longer-term horizon, there is value in the 7-15 year range. The muni yield curve is steep and it makes sense to consider extending maturity. If economic growth continues to be slow or the economy weakens, the curve may flatten resulting in positive muni performance.

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