RIVERBEND
Capital Advisors

Market Comment 12/22/12

The Recent Muni Sell-Off

While 2012 has been another stellar year for municipal bond market performance, December has not been very good. We believe this deterioration can be attributed to a combination of factors, including a 20 basis point rise in the yield of 10yr UST's, profit taking by fund holders anticipating the January 1st capital gains tax rate increase, typical year-end diminished liquidity as trading desks "shut down", unfavorable supply/demand technicals and uncertainty about the tax treatment of munis going forward.

Treasury yields rose in seeming reaction to what once appeared to be progress in the fiscal cliff negotiations that began after Thanksgiving, as some of the flight-to-safety bid left the U.S. Treasury market. To an extent, muni yields have followed.

Given the strong performance of the muni market in 2012 and the increase in capital gains rates scheduled to take effect on January 1st, some mutual fund holders have decided to lock in their gains at current rates. This in turn has led to redemptions and fund selling at an inopportune time of the year.

The timing of this selling is unfavorable because muni trading desks have generally had a good 2012, and traders are reluctant to jeopardize their P&L for the year by taking too much risk in December. While funds need to sell in the face of redemptions, the bid in the market is not being supported. This seasonal phenomenon is typical and the unfortunate result is diminished liquidity as we roll into year-end.

New issue supply was extremely heavy during the first two weeks of December as municipalities rushed to get deals to market before the holiday hiatus, which can last into late January. The 30-day visible supply peaked in mid-December. The muni market is often driven by supply technicals, and it has been a challenge to absorb the significant new issuance that we've been faced with this month.

There has also been concern in the market surrounding the future tax treatment of munis. President Obama has proposed lowering the value of many tax deductions and tax breaks for high income households. Among the proposals is a provision to cap the tax benefit of munis at 28%.

The Tax Exemption

Tax-exempt bonds are the primary financing mechanism for state and local infrastructure projects. They have existed for over 100 years and the size of the market is nearly $4 trillion. They are an essential funding source for state and local governments, who in turn are responsible for more than three quarters of all infrastructure projects in the United States.

Any reduction in the tax exemption will force states and municipalities to pay significantly more to finance projects such as highways, bridges, schools and water systems. This in turn will lead to fewer projects and jobs. Such an outcome would be very regressive as it would ultimately result in higher state income tax, sales tax, property tax, water & sewer fees, etc, which will affect all citizens.

Bounce Back?

There are approximately $30 billion in coupon interest payments and bond maturities coming on January 1st. These rollover peaks often cause demand spikes as investors seek bonds to reinvest the proceeds.

Going over the cliff means higher taxes across the board in 2013. Higher income tax rates make the tax-free income from munis that much more attractive and valuable. Traditionally there is little new issuance in the first few weeks of the year, potentially leading to a favorable supply/demand dynamic in the market.

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