October Municipal Bond Commentary

Solid Citizens of the Bond Market… Including the Occasional Crazy Uncle

October 13, 2015

Resilient. Steadfast. Workman-like. These are the words that come to mind when I think of municipal bonds. The past few months of volatility in equity and bond markets alike have reminded investors that muni bonds, particularly investment grade/intermediate maturity munis, can hold up reasonably well as they go about their business of providing attractive after-tax income. In the choppy markets we've been experiencing lately, many investors have learned to appreciate (or appreciate *again*) the solid citizen nature of municipal bonds.

Municipal bonds in the intermediate maturity range (six to twelve years) have had a total return year-to-date of 2.2%, according to the Barclays Municipal 7- and 10-year indices. Other parts of the muni bond yield curve have also had positive year-to-date returns, albeit somewhat below those of the intermediate range. Since the mid-August market choppiness caused by concerns about China, ten-year high grade muni bond yields have fluctuated in a reasonably tight range of 26 basis points. This is less than 10-year Treasury yields and comfortably less than corporate high yield paper over the same time period.

The supply of new-issue muni bonds so far in 2015 has been higher than last year, so much so that this year will likely be the first time since 2010 that the muni market will *not* shrink in size. However, the additional supply has not been large enough to overwhelm investors or to cause an absorption problem of any magnitude for the muni market. On the demand side, net money flows for muni bond funds have been consistently negative since May but the size of the outflows has been relatively modest. Despite this, year-to-date net flows to muni bond funds are positive to the tune of $3.3 billion. The ongoing demand for muni bonds remains an underlying strength for the market.

All this talk of munis being the solid citizens of the bond market must be balanced with what I call the usual suspects for muni credit headlines – Puerto Rico, Chicago, Illinois, and New Jersey – that are still causing consternation. Pennsylvania, with its recent budgetary disputes, has probably earned a spot on this list as well. The existence of such a list (and there is *always* a list) highlights one of the fundamental

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contradictions of the muni bond market. Considered in its entirety, the muni bond market is incredibly vast and diverse… and might be considered overwhelmingly safe, given the low percentage of actual defaults. At the same time, there exists real bits of individual mischief that wait for unsuspecting, uninformed muni bond investors. There are real potholes that need to be avoided and falling into one can be the very opposite of what investors expect from the bond market's usual solid citizen. Many families recognize and deal with the occasional crazy uncle in their midst and I suppose the muni bond market must too.

Credit news regarding the "usual suspects" will continue to ebb and flow, particularly for Puerto Rico, and credit spreads will adjust accordingly. Puerto Rico's story will be drawn out, complicated, and contentious. I believe the other issuers on the list have the tools to find more secure financial footing, although investors can count on plenty of newsworthy political wrangling along the way.

Over the past few years, the resiliency of the muni market has been amply demonstrated. Some observers thought the problems of Detroit and Puerto Rico were surely emblematic of all munis and that the asset class as a whole would be negatively impacted. To a large degree, the muni market has shaken off Detroit and Puerto Rico because experienced muni market participants understood that long-developing negative factors unique to those two issuers did not pertain to the vast majority of issuers. Long-time muni market participants also never lost sight of the very nature of the muni market itself: its incredible number and diversity of municipal bond issuers and how the overwhelming majority continue to go about the daily business of appropriate stewardship and debt repayment. This is not to dismiss the seriousness of the budgetary challenges and pension issues many muni bond issuers currently face. They require attention and vigilance. My point is simply that the muni bond market remains too large, complex, and fractured to be painted simply with a broad brush. It remains comparatively inefficient and is still primarily a bottom-up, bond picker's market.

Because of the characteristics of muni bonds outlined above (and because I suspect that the Federal Reserve is likely to place a fair amount of time between rate hikes), I believe excessive attention on the precise timing of Fed Funds Rate target hikes is misplaced for municipal bond investors. It is better to simply get in the game with a portfolio designed appropriately for an investor's unique objectives and risk parameters than to get too caught up in selecting the perfect entry point.

Munis by the Numbers *Sources: Bloomberg, Barclays Capital*

When does **2.70%** = **4.77%**? When you are an individual investor subject to the top Federal income tax brackets and you capture a **2.70%** yield from tax-exempt municipal bonds.

The **2.70%** yield stated above is our conservative estimate of an average yield-to-maturity for a muni bond portfolio constructed under present market conditions with the following parameters: all investment grade credits, an overall average credit rating of A1/A+, all bonds maturing within 15 years, an overall average maturity of 6 to 7 years, and a portfolio duration range of 3.7 to 4.7 years.

10-year *High Grade* Muni bond yields as a percentage of 10-year Treasury bond yields: **102%** (compared to an average ratio of 99% for the past ten years).

+1.26% March total return of the Barclays 3-Year Municipal Bond Index (+0.16% YTD, +1.51% for all of 2014)
+1.99% March total return of the Barclays 5-Year Municipal Bond Index (+0.31% YTD, +3.19% for all of 2014)
+2.20% March total return of the Barclays 7-Year Municipal Bond Index (+0.30% YTD, +6.09% for all of 2014)
+2.19% March total return of the Barclays 10-Year Municipal Bond Index (+0.33% YTD, +8.72% for all of 2014)
+1.97% March total return of the Barclays Long Municipal Bond Index (+0.29% YTD, +15.39% for all of 2014)

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