RESEARCH COMMENTARY
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MUNICIPAL MARKET UPDATE:
An Evolving "New Normal" for Municipals

Since the beginning of the financial crisis in 2008/2009 much has happened to the dynamics of the municipal bond market, both internally and externally. While the initial reaction was an expectation that the market would eventually revert to something like its previous condition after the crisis passed, the reality is that the marketplace has substantially changed and will remain so for the foreseeable future. In the last six months the outline of the new market equilibrium has come into view and begun to be accepted by market participants. All of these changes only serve to reinforce our ongoing strategy of separate account management, using municipal bonds issued by high quality, stand-alone credits with vital-service or tax based revenue streams supporting the debt service.

A Series of Setbacks

Having been negatively affected by the loss of AAA ratings by bond insurers and the loss of credibility by the rating agencies, municipals have been further impacted by a cyclical crisis of regulatory and compliance changes (affecting underwriters, issuers, brokers, and investment managers). As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, many new regulations have been imposed that have forced underwriters to reduce exposure to the business because of increased expenses. The net effect of this Act has led to a decrease in liquidity that has pressured brokers and advisors to curtail their direct service to the retail sector. These complicated changes have also been affected by the federal government's fiscal stimulus, specifically the creation and sunset of the Build America Bonds (BABs) program, which caused havoc with the market's supply/demand balance last year.

At the issuer level, the efforts to reign in state deficits have created headlines and public demonstrations. Unlike previous cycles, federal assistance would not be forthcoming, forcing the stated economic adjustment period to be significantly longer.

These deficit-reduction activities have been grist for the media's mill. In their desire for controversy, they have framed the narrative as one of "class warfare", and have made no distinctions across multiple sectors of municipal bonds, ranging from state general-obligations to local development districts. Further, the media and new, self-appointed "experts" have confused cyclical with long-term problems. Retail investors have read the headlines but have not understood the details, while both political officials and the media have manipulative agendas. The result has been lower liquidity as "panic selling" in retail accounts continues at a minimum, while also refraining from adding new exposure.

Yields, Valuation, and Credit Spreads

All of the above has changed municipals from a "commoditized" market, with narrow spreads based on rating categories and fungible insurance, to a "credit" market driven by analysis of the individual issuer and security structure. It is important to understand what yield, valuation and credit spread shifts have resulted, and where they have stabilized.

On the following page, we contrast the recent events to 2007, the year before the height of the crisis. We provide a "before and after" comparison for the MMD AAA national yield curve, the US Treasury yield curve, the spread between the AAA and A municipal curves, and the ratio of AAA municipals to US Treasuries. The following can be observed:

- Both taxable and tax-free yield curves have steepened markedly, with municipals remaining somewhat steeper than Treasuries.
- The bulk of the yield change has occurred in the front of the curve, in shorter maturities. This has been driven by Federal Reserve monetary accommodation. Long rates have seen less of a widening and are actually pretty close to where they were before the crisis.
- The ratio of municipal to Treasury yields has risen across most of the curve, with the exception of the five year area.
- Municipal inter-market credit spreads have widened dramatically. Single A spreads to AAA, which were under 50 basis points previously, have risen to between 150 -200 over most of the curve.

Conclusions

When we factor in the decreased liquidity available to the municipal market, discussed previously, to the data above, certain conclusions can be drawn:

- The municipal curve is naturally steeper than the Treasury curve. Treasury supply remains heavily weighted to the front of the curve and tax-exempt municipal supply to the longer end, especially after the sunset of the BABs program. The municipal curve should remain steeper even if both curves flatten.
- Curve steepening has been mainly driven by Fed accommodation at the front of the curve, and not by inflation fears at the back. Therefore, the likely course of events should be curve flattening as accommodation is withdrawn, with short rates going up much more than long rates.
- Municipal to Treasury yield ratios should remain higher over the intermediate to long part of the curve, reflecting the lower liquidity. The seemingly expensive municipal 5-year is probably due to crowding in from both ends, due to the low absolute money market yields below and credit and inflation fears above.
- Municipal credit spreads should remain wide and narrow only very gradually if at all. The bond insurance industry is critically, if not fatally, wounded, and the rating agencies are discredited (somewhat unfairly with regard to municipals). Both conditions will take a long time to heal.

Additionally, there are some market positives that are beginning to play out:

- Municipal revenues have stabilized, and risen for the last four quarters. This trend is expected to continue into this year.
- Expenses are forcefully being addressed at both the state and local level. The political turmoil is, paradoxically, a sign of progress as “sacred cows” are gored. While the cutbacks, especially in municipal employment, are not a positive for national economic growth, they are a credit-plus for the individual issuers.
- Supply should remain subdued, both because so much was crammed into the last quarter of 2010 to take advantage of the expiring BABs’ subsidy, and because of the ongoing cutbacks at the state and local level. YTD municipal issuance is 55% lower than last year.

Consequences and Strategy

The current state of the market is a distinct positive for independent advisors, such as SAC. We have always been focused on underlying credits and security structure when purchasing portfolio positions, we have emphasized quality credits for their liquidity as well, and we have always advocated taking prudent advantage of the absolute and relative steepness of the municipal curve.

Going forward, we think the following strategies make sense for separate municipal accounts:

- Take advantage of the yield curve. Not only are you being rewarded for taking on even small increments of longer duration, the return from “rolling down the curve” over the course of a year can be substantial and a cushion against any tightening by the Fed. The shorter end of the curve will probably see sharper rises than the long if the curve “normalizes”.
- Favor high quality revenue bonds with vital service or dedicated tax cash flows over general obligations. They are subject to considerably less “headline risk” and often have superior positions in the security structure.
- Balance the portfolio between AAA–AA credits for liquidity, and quality single A credits for yield enhancement. This requires the strong analytical abilities of a professional manager.

We believe current municipal market yields represent excellent long-term value, especially when compared to taxable equivalents, for individual investors subject to federal, state and local income taxes. We also believe that making a substantial commitment to this sector benefits, more than ever, from professional management to navigate a market that has become less liquid and more dependent on in-depth analysis of individual issuers and security structures.