Redstone Advisors

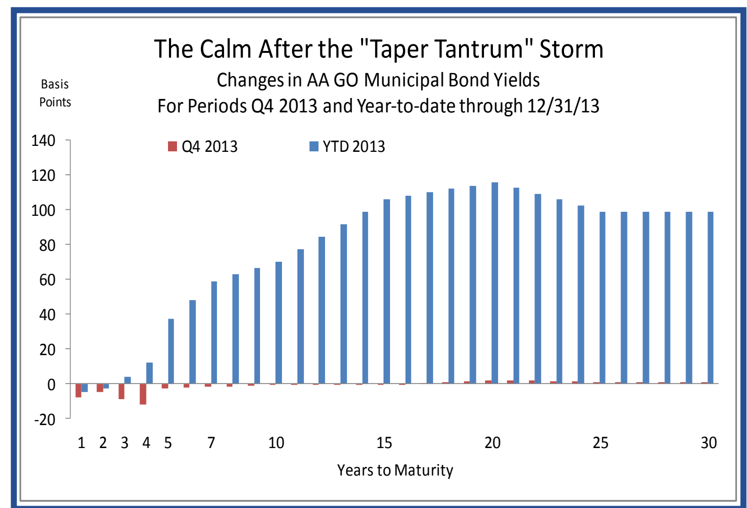
# Municipal Market Review

Fourth Quarter 2013

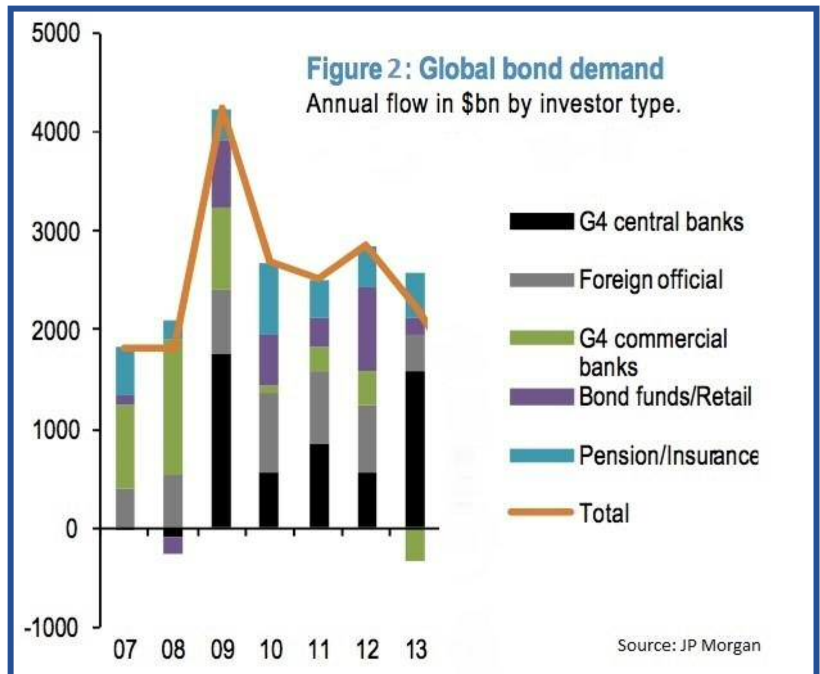
The fourth quarter of 2013 witnessed a **stabilization** of municipal yields following the decline in yields that occurred during the third quarter. Due to the Fed's surprise **"no-taper-today"** announcement in September, the market was effectively on hold during the fourth quarter, awaiting the FOMC's decision regarding the tapering of its $85 billion monthly bond purchases. As central-bank buying totaled **$1.6 trillion**, which accounted for more than half of the total demand for bonds in 2013, it is easy to understand why the markets were so concerned about the timing and scope of the taper. The breakdown in global bond demand can be seen in **Figure 2.** The Fed ultimately decided to **modestly trim** its purchases by **$10 billion per month** to $75 billion per month, taking the first step toward winding down its unprecedented monetary stimulus. During the fourth quarter of 2013, the municipal yield curve experienced a slight steepening as short and intermediate-term yields declined modestly while yields on longer term bonds in the 10-30 year maturity range were essentially unchanged. At its December meeting, the Fed stressed that its key benchmark interest rate is likely to stay low *well past the time* that the unemployment rate declines below 6.5 percent.

This past year the municipal bond market experienced its first negative total return since 2008. As measured by the Bank of America Merrill Lynch master municipal index, municipals as a sector fell 2.6 percent in 2013, the worst year for the index since 1994. Municipal bond yields backed up this year in anticipation of the Federal Reserve's tapering of its monthly purchases of Treasuries and mortgage-backed securities, news of Detroit's bankruptcy filing and Puerto Rico's budget woes, and the migration of some crossover buyers to risk markets. The reshaping of the yield curve is reflected in **Figure 1** which graphs the changes in municipal yields across the curve for both the fourth quarter and for the year-to-date period through December 31, 2013. As we can see in **Figure 1**, for the year, municipal yields rose significantly in the 7-to-30-year area. Only the 1-to-2-year segment saw yields slightly decline for the year, remaining essentially

**Fig 1**



unchanged. For the year, the yield on the 10-year Treasury note rose to as high as 3.01 percent in December from as low as 1.61 percent in May. Similar to municipals, Treasury yields ended the year higher along the yield curve. Municipal relative value ratios for the quarter were lower across the yield curve. Despite the modest decline in relative value, municipals continue to be attractive as relative value ratios remain above 100 percent for 1-3 year and 15-30 year maturities, and in the 80s to 90s for the 4-10 year segment.




You may recall that the financial media and many market commentators have been predicting rising interest rates ever since the aftermath of the financial crisis in late 2008. That was the time when the Federal Open Market Committee (FOMC) cut the federal funds rate to its lowest level in history, 0.0 to 0.25%, implementing their zero interest rate policy (ZIRP). Five years on from the crisis, the economy remains mired in below potential economic growth, stubbornly high levels of unemployment and stagnant income growth. And despite having risen from their June lows in response to Fed's threat of an imminent taper, interest rates remain at historically low levels. And while there has been much discussion regarding the negative impact that rising interest rates may have on a bond portfolio, there has been less discussion about the unique benefits that a portfolio of actively managed high-quality municipal bonds offer to investors whose primary objective is wealth preservation. These advantages include contractual and predictable cash flows, positive carry and lower volatility. At Redstone we believe high quality bonds in the short to intermediate maturity range provide the best defensive strategy against potentially rising rates in the aftermath of the Fed's decision to start tapering. Shorter duration bonds safeguard the value of our clients' portfolios since they are comparatively insensitive to a rise in interest rates while allowing us to actively reinvest at higher rates if and when rates should rise. Meanwhile, intermediate holdings have the advantage of benefitting from higher tax-exempt yields.

Broadly speaking, credit conditions for states and local governments are continuing to improve reflecting the efforts of state and local governments to balance their budgets coupled with the modest rise in home prices and recovery in property taxes. We favor the general obligation, essential service and infrastructure bonds of well-managed issuers with sound finances, stable economies and manageable debt levels. Furthermore, you might remember that over the past several years, as interest rates have fallen to historically low nominal levels, we have

consistently emphasized high coupon premium bonds in client portfolios as a defensive measure in anticipation of a probable rise in interest rates. Those premium bonds, while negatively impacted by the rise in yields, were less negatively impacted than par or discount bonds. Also the premium paid on high coupon bonds results in larger periodic cash flows due to the return of a portion of that premium with each coupon payment, effectively bringing forward the payment stream and allowing increased reinvestment in a rising rate environment.

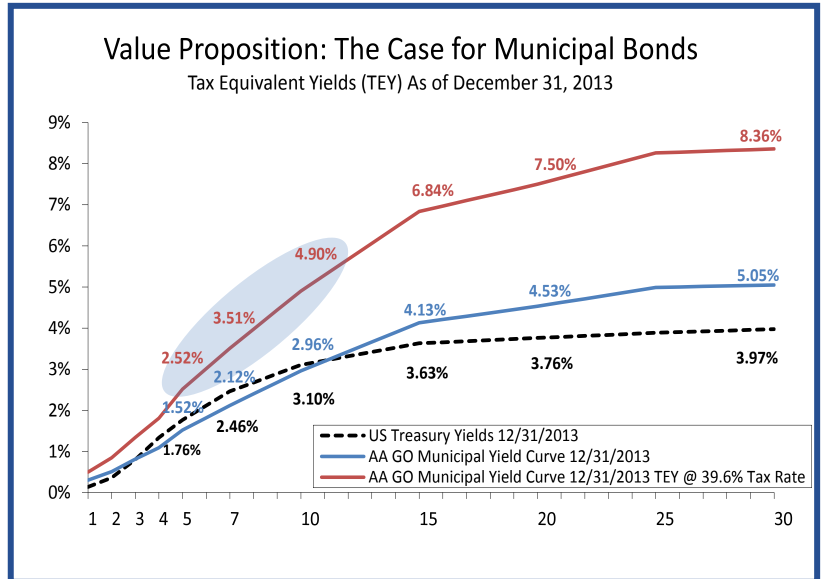
Municipal bonds have been on the receiving end of some negative press, particularly after Detroit's Chapter 9 bankruptcy filing. Unfortunately, media fear mongering has helped stoke irrational fear among some investors. The reality is that the historical default rate for munis is near zero. Looking at the big picture, including all of Detroit's debt in default, year-to-date defaults through the end of November were $2.47 billion, or just **0.08% of the $3.7 trillion municipal market.** Troubled issuers should remain a relatively small part of the market yet grab an outsized share of media attention relative to the broad majority of the sector which continues to display improving credit health. We see the situation with Detroit as unique and in no way representative of an underlying systemic problem within the municipal market. The vast majority of historical municipal defaults cited in discussions are in the health care and housing project finance sectors, not general local and state governments. It is important to remember that governments have captive tax bases and strong control over taxing and spending. All but one U.S. state and most local governments have a legal balanced budget requirement. Debt levels are relatively low and annual debt service is a small part of budgets. In addition, bond security is very strong for most debt issuances. We see the municipal market's underlying fundamentals as strong given that **state revenue collections have risen for 15 consecutive quarters** while spending is declining. This past quarter has been a compelling buying opportunity for investors as municipal yields return to levels not seen since 2011. Plus, this is happening at a time when broad market fundamentals are healthier than they have been in the five years since the 2008 financial crisis. Data coming in this quarter shows normalcy gradually returning to the municipal market as reflected by a recent Bloomberg News article that noted that municipal issuers are defaulting at the slowest pace in at least four years.

At the end of December there had been a record 32 consecutive weeks of outflows from U.S. municipal bond mutual funds in 2013, according to data from Lipper FMI. This withdrawal has totaled nearly $63 billion for the year. In response to rising rates caused by taper fears, many investors abandoned their municipal holdings. This was a big theme of 2013, as you can see in the upward movement in municipal bond yields that occurred over the course of the year. In the midst of the steady selling, we saw in November a special opportunity where munis were especially attractive at prices lower than they had been in quite some time after mutual fund investors dumped the securities for 28 straight weeks. As we mentioned last quarter, this forced sell-off due to mutual fund withdrawals acted to **restore value** in an overbought market, essentially opening a window of opportunity in which to deploy capital at higher entry yields for those who are positioned to do so.

We continue to believe that due to certain inherent characteristics unique to municipal bonds, they are best suited to ensure safety of principal and attain adequate return. Bolstering municipals appeal is that they continue to

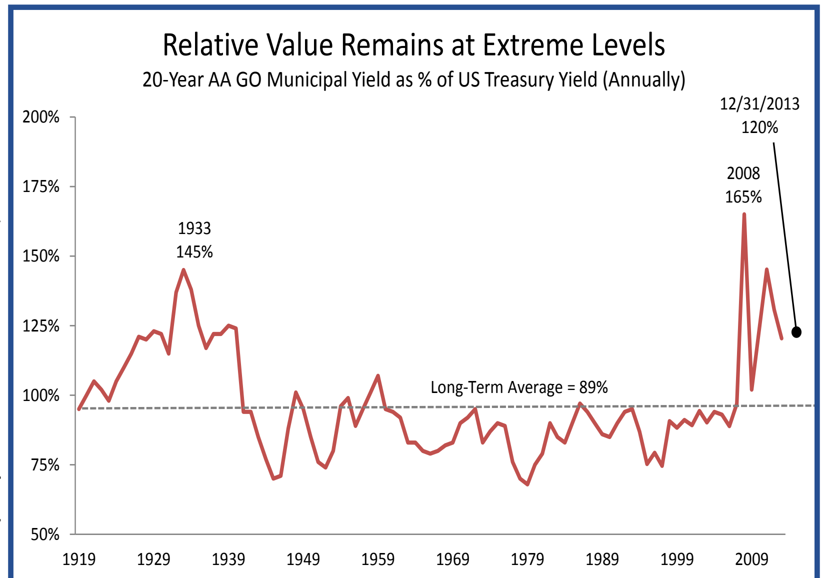
offer historically very good relative value as the chart on **Figure 3** indicates. Investors sometimes focus just on nominal yields in the determination of value and fail to consider the real value inherent in high quality municipal bonds, their tax exemption. The value of this tax exemption also benefitted from the rise in bond yields during the last quarter and year. As such, a 5-year municipal bond priced to yield 1.52%, offers a **252 basis point pick-up** over cash when yields are tax adjusted. Likewise, a 10-year bond priced to yield 2.96%, offers a **490 basis point increase** over cash when yields are tax adjusted. And don't forget that the value of the interest exemption in an investor's portfolio compounds over time, which can have a powerful impact on the growth of a portfolio's par value across time.

**Fig 3**




Despite the fact that bond yields rose over the course of 2013, the **relative value** of municipals, as measured by the ratio of municipal yields to Treasury yields, continues to remain at **historically high levels**. **Figure 4** shows the relative value ratio of the 20-year municipal bond versus the 20-year Treasury bond on an annual basis since 1919. As evident, this measure of relative value, at **120 percent**, remains **30 percent higher** than its long-term average of 90 percent. In addition to attractive relative value, municipal yields present investors the opportunity to lock in attractive absolute value by extending maturities out the yield curve from cash. As previously mentioned, the backup in longer dated maturities coupled with the Fed pinning down the short end of the yield curve has resulted in a modest steepening of the municipal yield curve. The 2s-to-10s spread of the municipal yield curve at the end of 2013 was **245 basis points**, steeper than its long-term average of 137 basis points for over the past five years. As we have said before,

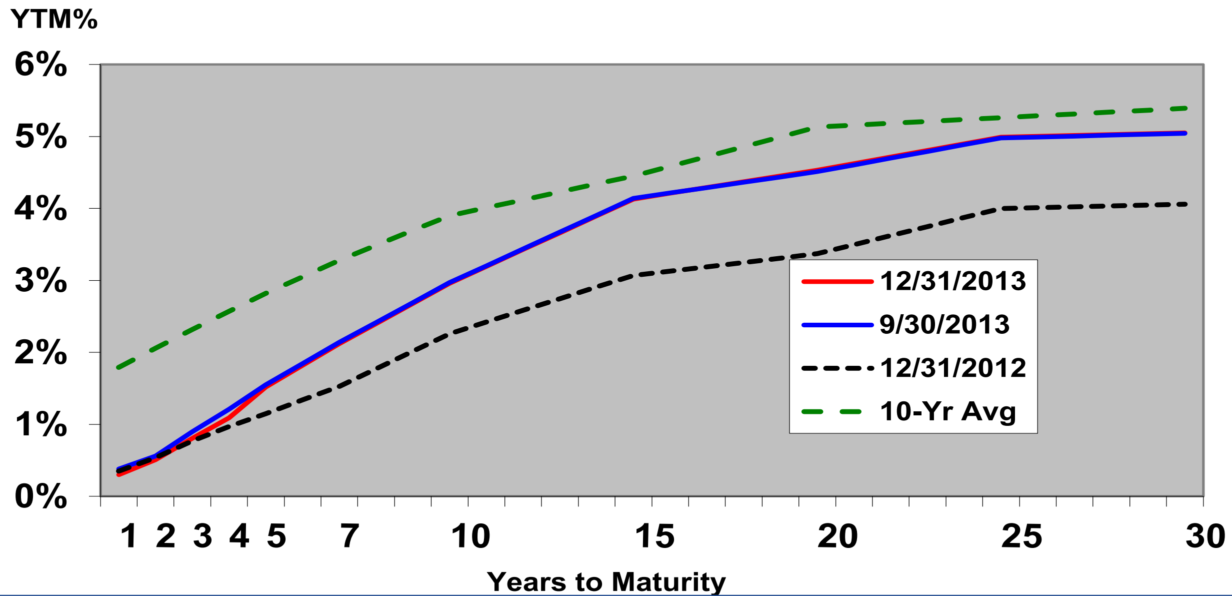
**Fig 4**

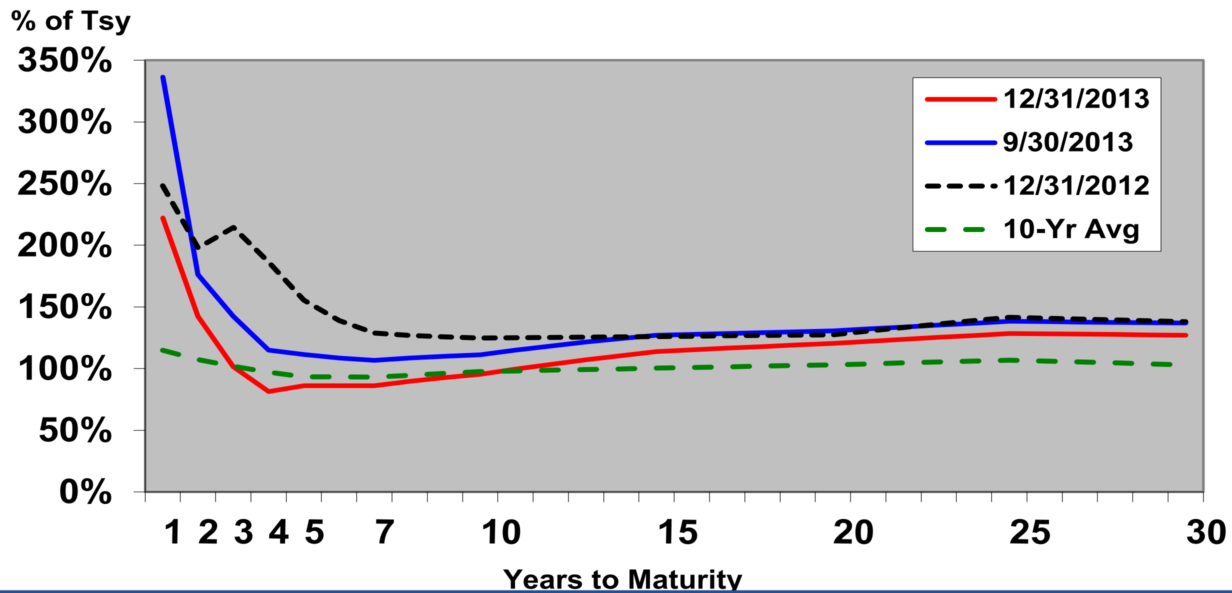


a **steep yield curve** offers investors the opportunity to lock in higher absolute yield levels [read income] and along with those yields long-term tax benefits by extending maturities. This most recent rise in rates offers investors the chance to pick up increased incremental term premiums with modest extensions in the intermediate part of the yield curve, making, in our opinion, intermediate maturities more attractive than short or long-term yields on a risk-adjusted basis.

A development of note in the municipal market making news this quarter is the increased presence of hedge funds. A November Wall Street Journal article mentioned how hedge fund managers see their strategies as benefitting all municipal bond investors by leading to more frequent trading, more transparent bond pricing and increased disclosure by government officials seeking to sell debt. Some hedge fund executives have called their own entrance an “important evolution of the municipal marketplace” and a step toward “more robust pricing, more robust liquidity and greater investor security across the board.” Municipal-bond analysts note that hedge funds now hold billions of dollars’ worth of distressed municipal debt, an increase from essentially no investments five years ago. Proponents say the new hedge fund presence adds liquidity at a time when traditional providers have pulled back and helps drive inefficiencies out of the marketplace. Their argument is that in the long run, it should be a good thing for the market as an asset class to have a wider audience, and to become more of a global fixed income asset class. We tend to have a more skeptical opinion of the impact of these crossover buyers or **“vulture capitalists”** moving into the muni market. We would certainly be concerned about the potential short-term volatility and **questionable dependability** of these hedge funds. It is not hard to envision a scenario where the markets turn negative again and these hedge funds will all scramble to try to leave at once after picking through the bones of the distressed debt of Puerto Rico and other troubled municipalities. Hedge funds have entered as broker-dealers have withdrawn from the municipal market in significant numbers. The main reason for this withdrawal seems to be increased regulations, mainly those of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which has set stricter capital requirements and risk parameters that have discouraged banks from participating in the market as much as they used to.

Over the course of 2013 many municipal investors sought a safe haven from the forecasted storm of rising rates. Redstone Advisors, with our 25+ years of municipal bond expertise and personalized separate account management, believe we are uniquely qualified to provide wealth preservation through building par value by maximizing tax-adjusted purchase yields while avoiding credit events. Looking to the past, **municipal bonds have historically outperformed Treasuries when the Fed tightened the money supply**, and we at Redstone look for that scenario to play out again as the Fed ever so gradually shifts from six years of very accommodative policy. Ultimately, we believe the increased after-tax benefit of municipal bonds will be very clear and welcoming after investors digest the impact of the higher federal tax rate of 39.6% and the recently enacted Medicare Investment Tax of 3.8%. After a challenging year, we recommend investors remain focused on municipal bonds for their high-quality, tax-exempt income, the very traits that make these bonds the **last great tax shelter** for individuals in high tax brackets.




| | 10 Yr Avg | 9/30/2013 | 12/31/2013 |
|---|---|---|---|
| 2-Year AA Municipal | 107% | 176% | 143% |
| 5-Year AA Municipal | 93% | 111% | 86% |
| 10-Year AA Municipal | 97% | 111% | 95% |
| 25-Year AA Municipal | 106% | 138% | |