Municipal Commentary

3rd Quarter 2018

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Tax-exempt bonds traded in a narrow range for the third quarter, with a keen eye on macro issues that dominated the headlines for much of the period. A seasonally slow period was made worse by developments in global trade and tariffs, the composition of the US Supreme Court, and forecasting the impact of the upcoming midterm elections. These issues led to uncertainty around rates and kept many bond investors on the sidelines waiting for a clearer signal on market direction.

Key Takeaways

- Variable rate demand notes (VRDN) and ratios
- Performance
- Macro paralysis

VRDO's and ratios

Infrequently, municipal buyers are better off buying taxable bonds and paying the tax rather than buying tax-exempt paper. We saw one of those occasions during the third quarter in the variable rate demand obligation (VRDO) market and the short end of the yield curve. July is a large reinvestment period each year as bonds mature in large dollar amounts, and it generally coincides with a seasonally weak new issue calendar. This creates a great deal of cash that sits in money market funds or short-term paper until issuance improves and can push short-term rates and ratios to taxable bonds lower. This year VRDOs dropped to 1.00% at the same time that three month, "A" rated corporate bonds were yielding 2.10%. Even government money market sweep rates at the time at 1.80% were better than municipals on an after-tax basis. This seasonal dislocation was short-lived, and VRDO rates moved higher after a few weeks However, short-term fixed rate bonds remain somewhat expensive relative to their taxable peers, posting ratios to taxable bonds that continue to be low historically.

Performance

During the second quarter, municipal bonds saw positive performance at all points on the curve, which helped bring performance positive year-to-date on the front end of the curve. But this past quarter was nearly the opposite, with negative performance at all points on the curve with the exception of the 10-year Bloomberg Barclays Index at .06%. The worst spot was the Long Bond Index (22+ years), which returned -.48% for the period. Performance for the year remains positive inside of five years but turns negative longer, with the Long Bond Index again the worst performer year to date at -1.13%.

Macroeconomic headline risk

Many muni investors have remained in cash or VRDOs waiting for a better entry point in the market with expectations that the Federal Open Market Committee (FOMC) will continue to hike short-term interest rates. In addition, there are market distracting headlines that have the potential to keep the focus away from deploying short-term cash into the market. The ongoing confirmation process to the Supreme Court of Judge Brett Kavanaugh and the possibility of having to nominate a second candidate with a potentially different Congressional makeup after the midterm elections could have far reaching impacts. One of the issues that will face challenges in front of the US Supreme Court is the previous ruling against public sector unions (Janus) and certainly other potential state and local tax (SALT) workaround programs the IRS has said were unlawful. Finally, ongoing trade disputes with many countries, not least of which China, has the potential to keep investors wary about committing to an uncertain market.

Conclusion

An improving economic story domestically has much of the investor focus away from fixed income, which is backed up by municipal mutual funds reporting net outflows for the month of September. With new issuance down 16% compared to last year, the outflows have been able to be absorbed by buyers with little difficulty. We continue to watch the new issue calendar and selling from banks that formerly were beneficiaries of the tax exemption from municipals. After the Tax Reform Act, those bank holders have been steadily reducing their exposure. Continued sell pressure from new issues and corporate holders selling could struggle to find liquidity in the face of the many macroeconomic issues that face the market in the near term.

For more information about how this impacts your portfolio, contact your Key Private Bank Advisor.

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Sources: Bloomberg Barclays, Bank of America Merrill Lynch, Citigroup, MMD