THE MUNICIPAL BOND MARKET – QIII 2012

Economic uncertainty continues to hang over the fixed income markets and municipal credit worthiness is being challenged. This is especially true as weak credits in California garner headlines as they look for relief from burdensome financial liabilities.
It is ironic that despite these negative hurdles, cash continues to flow into municipal bond mutual funds, rates are dropping, credit spreads are tightening and performance in the municipal market is ahead of expectations year-to-date. Navigating this marketplace requires strong credit research capabilities and a seasoned trading and portfolio management team dedicated to the space; something we continue to work hard at and be proud of in our service to clients.

While equities rallied in the third quarter of 2012, we also saw positive movement out of the fixed income markets, as rates dropped across the municipal curve, albeit more so on the long end, causing the municipal curve to flatten. There has been little improvement in any economic indicators or employment measures, clearing the path for further asset purchasing and accommodative policy by the Fed, while the EU has also promised supportive measures to preserve solvency in their banking system. Second quarter GDP came in at 1.5%, near the more conservative side of estimates. Current growth through year-end is likely trending at or below this level. The uncertainty of the election and the Fiscal Cliff likely are restraining consumer and business spending, which could hamper fourth quarter GDP. Employment remains weak due to a declining labor force participation rate. We are seeing signs of life in the housing market and remain optimistic that low rates will continue to help this sector grow.

In the statement from the September meeting, the Federal Reserve announced that it will enter into a third round of quantitative easing in the hopes that it will stimulate the slow-moving economy and help brighten the sluggish employment picture. The Fed has committed to an open-ended purchase of additional Agency Mortgage Backed Securities and long US Treasury debt in order to keep rates low through mid-2015. Additionally, the Fed has stated that it will do “whatever it takes” to continue to support the markets. As we move closer to year-end and into the beginning of next year, the employment numbers will be the principal factor in determining the length of the Fed’s commitment to this policy. Now we will have to see if this is sufficient to sustain economic growth, or if a lack of clarity on US fiscal policy, and concerns internationally will jeopardize the recovery.

We continue to see improvement in state-level revenues with the Rockefeller Institute releasing preliminary data showing a 3.0% increase in state tax collections for the second quarter of 2012, compared to the same period in 2011. State revenues have now grown for ten straight quarters after declining for five consecutive quarters following the recession. The pace of growth will be important to watch going forward, as the rolling four-quarter average has slowed to 4.2% growth compared to 8.9% just one year ago. Local credits on the other hand remain challenged as state aid has dropped and local revenues are stagnant, namely property taxes.

The most recent name to grab the headlines is Atwater, California. Atwater, like the other California towns in the headlines, fits a profile of inland, agricultural town, boom-bust housing market, with weak underlying economies being stressed due to the prolonged downturn. We continue to rely on our diligent credit research to avoid these types of securities.

We entered the third quarter with municipals trading cheap to Treasuries, with the 10-year Municipal Treasury ratio at 111.4%. We indicated that this level of cheapness of municipals to treasuries would help municipals in the near-term and it did, causing the ratio to drop to 103% at quarter-end. At this level municipals remain “cheap” relative to their taxable counterparts which will continue to support the market. This is evident by the increase of non-traditional buyers in the municipal space: Non-US buyers and Banks. In fact, Banks are now on pace to become the third largest buyer of municipal securities, replacing the spot held by insurance companies.

Performance in the quarter was driven by curve selection, as yields fell across the curve for the quarter, although the 10-year part of the curve did experience a bit of volatility. We had two periods during the quarter where 10-year Municipal yields sold off by 20 basis points, only to be met with a rally. The most dramatic rally was the movement into quarter-end as the 10-year dropped 23 basis points to a 1.70% and continues to have a strong bid side. Overall for the quarter, 10-Yr AAA municipal yields were down 16 bps to finish at 1.70%.

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Despite a drop-off in municipal issuance in September, issuance remains elevated for the quarter and year-to-date over the same period in 2011. Volume is up 44% over 2011, $278 billion versus $193 billion; issuance in the quarter was up 11.5%. Leading the charge for new issuance remains the dramatic pick-up in refundings, which are up 91%. The majority of these refundings have been current refundings of bonds that are within 30 – 60 days of their next call date. Advanced refundings (call dates at least 6 months out or longer) have been difficult in 2012 since municipal rates have exceeded treasury rates at different points, creating a negative arbitrage situation which prevents advanced refundings.

One of the continued themes in 2012 is the strong inflows into municipal bond mutual funds. Through quarter-end, $39.6 billion has flowed into the funds and over $44 billion has been added since this current in-flow trend began, marking 43 consecutive weeks of inflows into the municipal market. Almost half of the inflows, $19.2 billion, are going into long-term municipal mutual funds, while Intermediate Funds and High Yield Funds took in $9.5 billion and $8.5 billion, respectively. These inflows, along with the much discussed “net-negative issuance” which was heightened over the third quarter, are contributing to the strong bid-side for municipals, which has led to credit spread tightening as investors reach for yield. Over the quarter, we saw AAA over BBB credit spreads tighten 29 basis points from 191 bps over to 162 bps. “A” rated credit spreads tightened up 5 bps over AAA credits for the quarter. Credit selection continues to be a significant part of our management process.

We remain focused on positioning our portfolios in the current environment to help manage through the economic uncertainty, low rates, and volatile credit markets. One area where this prudence is helping us is our preference for non-callable bonds and only buying callable bonds where the time between the call and the maturity is typically 1 to 3 years.

Looking ahead, strong fund inflows will absorb the expected increased issuance in the fourth quarter providing underpinnings of strength. We continue to believe the Fed remains on hold due to heightened concerns over Europe, Asia, and our own domestic economy. The election around the corner and the looming Fiscal Cliff in January will keep interest rates range bound. Municipal valuations are attractive, the yield curve is steep and the Fed is on hold. Thus, we will maintain our intermediate duration target at 5.0 years at this time and will remain diligent in our credit efforts. Even in this low yield environment, an intermediate municipal portfolio is a defensive investment that generates income, and given the alternatives, still remains a prudent allocation in your overall investment portfolio. We will continue our goal of finding value in the municipal market on behalf of our clients.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives.