Municipals: Safe Port in a Storm

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In an uncertain world, safety is in high demand. US municipals benefited from Britain’s contentious vote to exit the European Union. Could anything knock them off course?

US municipals rallied in the wake of Brexit. The highest-quality munis led the rally that Friday, then mid-grade and high-yield municipals more than caught up early the next week, prior to the equity market bouncing back. In fact, mid-grade and high-yield municipals eventually outperformed high-grade muni debt.

That made sense: the markets were orderly, Britain is far away, and the impact on our economy is likely to be modest. Indeed, somewhat slower US growth should dampen inflationary pressures and delay a potential Fed rate hike, which is actually positive for most lower-grade municipal bonds. When rates are lower for longer, investors’ need for income grows.

Got Stability?

But lower-rate expectations weren’t the whole story behind the rally.

Municipal investors generally look for two ingredients—safety and income. These are in especially high demand in today’s uncertain, low-income world. Historically, municipals have been safe, and as long as the US economy continues to grow, they are likely to remain safe.

Municipals additionally offer most US investors a tax exemption, giving munis a higher after-tax income than US Treasuries and corporate bonds. As a result, US$33 billion has poured into municipal mutual funds year to date, according to Lipper Analytical Services.

But even without the benefit of tax exemption, municipals appeal today. Perhaps surprisingly, foreign investors have been buying municipal bonds because they yield more than many of the high-quality alternatives available in their own countries. According to the Federal Reserve, over the past year the “rest of the world” bought US$7 billion in municipal bonds.

Strong and consistent investor demand for municipals has had to contend with a stable—rather than a growing—supply of munis. There is US$3.7 trillion of municipal bonds outstanding. That’s only about as much as there was five years ago. In contrast, the amount of marketable US Treasury securities has grown by US$3.5 trillion over the same period, while US corporate debt has grown by US$1 trillion.

That limited supply in the face of strong demand has led to high prices and low yields.

Few Clouds on the Muni Horizon

What could change the supportive dynamic between supply and demand in the weeks ahead? We never want to say never, but there doesn’t look to be much.

New issuance? New-issue supply is typically light during the summer. Record low interest rates will likely spur more issuance, but probably not enough to meet current investor demand: most new issues are well oversubscribed. Plus, even though municipal interest rates are lower this year than last year, new issuance for the first half of this year was below last year’s levels.

Puerto Rico? On July 1, the Commonwealth defaulted on half its interest and principal payable that day, including its general obligation bonds. At $1 billion, that’s the municipal market’s largest default on record. On the upside, the President signed PROMESA into law hours earlier, providing the territory the legal framework to restructure its debts.

Significantly, Puerto Rico first defaulted last August, and the municipal market rallied through that and each subsequent default. That’s an indication that investors recognize that Puerto Rico’s financial and economic problems are unique to...
Puerto Rico. The municipal market overall has rarely experienced defaults, Puerto Rico aside. In fact, municipal prices tend to be more stable than Treasury prices.

**Low interest rates?** This is where municipals' tax exemption really helps against the competition. Low interest rates could curb investor demand somewhat, but muni yields and potential returns are still more attractive on an after-tax basis than most safe alternatives.

**Tax reform?** Lower federal tax rates would indeed reduce the value of municipal bonds. However, tax reform can’t be on the table until after the presidential election.

With the likely persistence of a favorable supply/demand dynamic and ongoing uncertainty and volatility in capital markets, municipals should continue to play the role of safe haven in investors’ asset allocations.

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