Bloomberg

Munis Seen Reviving Rally After Two Months Trailing Treasuries

Thursday, November 27, 2014
by Brian Chappatta

Nov. 28 (Bloomberg) -- Municipal bond investors, including American Century Investments and Deutsche Bank Private Wealth Management, say it's time to buy as the debt trails Treasuries for the longest stretch in 15 months.

With supply reaching the highest level since April 2013, munis have lost about 0.1 percent this month through Nov. 25, Bank of America Merrill Lynch data show. That compares with a 0.6 percent gain for Treasuries, leaving the market for state and local debt poised to underperform federal obligations for a second straight month, the first time that's happened since July and August 2013.

Benchmark 10-year munis yield 2.23 percent, compared with 2.24 percent for similar-maturity Treasuries, data compiled by Bloomberg show. The ratio of the interest rates, at 99 percent, is close to the highest since February. That signals tax-free bonds are relatively cheap, said **Neil Klein** at **Carret Asset Management LLC**, Steven Permut at American Century and Gary Pollack at the Deutsche Bank unit.

"The ratio where it is today is a very compelling story to be buying munis," said Permut, who oversees about $6.5 billion of local debt as head of munis at American Century in Mountain View, California. "This is an ideal time for the investor who's looking for tax-free investments to be buying muni bonds."

Record Rally

Munis have earned 8.9 percent this year, beating company debt and Treasuries. They've defied analyst and investor forecasts for losses in 2014, instead rallying for an unprecedented 10 straight months as benchmark yields fell toward five-decade lows.

A dearth of supply this year has fed the demand. After trailing the 2013 pace for months, localities' debt sales are close to pulling even with last year's level, with about $270 billion of long-term, fixed-rate issuance. The annual figures for 2013 and 2014 are about 15 percent below the 2012 level.

Trailing Treasuries may leave the debt looking more attractive in the months ahead.

The bonds will experience "significant outperformance" relative to Treasuries in the three months through February, Peter DeGroot, a muni strategist at New York-based JPMorgan Chase & Co., wrote in a 2015 outlook published Nov. 26.

Ratio Reverie

From 2001 through 2007, before the 18-month recession and the financial crisis, the average ratio of 10-year muni yields to those on Treasuries was about 86 percent, Bloomberg data show. State and local debt historically has carried lower interest rates because of its tax-exempt interest payments, which equate to higher taxable yields for top earners.

For individuals in the top federal income-tax bracket, the 2.23 percent yield for AAA munis is equivalent to about 3.7 percent for taxable bonds.

The yield ratio fell to 86 percent in June for the first time in three years as munis beat Treasuries for a 10th straight month. The proportion may return to that level in 2015, said **Klein**, who helps oversee about $750 million in state and local debt for **Carret** in New York.

Pollack, who oversees $7 billion of munis as head of fixed-income trading at Deutsche Bank's private-wealth unit in New York, said he buys tax-free debt for taxable accounts as the ratio approaches 100 percent. The latest supply jump may provide a chance to lock in higher yields, he said.

January Effect

"Given the high ratios we have right now and the outlook for another light year of issuance, munis are attractive," Pollack said.

Municipalities offered about $65 billion of debt in October and November, the most in 19 months, Bloomberg data show. They've scheduled about $13 billion of deals for the next 30 days, the most for the period since 2012. Some states and cities set sales less than a month before borrowing.

If history is any guide, investors will have fewer bonds to choose from to start 2015. States and cities have borrowed about $19 billion on average in January over the past 10 years, the least of any month. The market is set to contract for a record fourth straight year as the schedule of sales falls short of the pace of redemptions and maturing debt, meaning investors stand to have more money to deploy than new bonds to buy.

Muni returns have averaged 0.8 percent in January since 1989, third-best behind May and July, Bank of America data show.

Benchmark 10-year muni yields will rise 0.32 percentage point from current levels by this time next year, compared with a 0.49 percentage point increase for similar-maturity Treasuries, JPMorgan projects. That would drive the ratio of the rates down to about 88 percent.

"Munis are a very good buy," **Klein** said. "Next year, even in a rising interest-rate environment, as long as things don't run away too quick, you could end up with positive returns with higher yields."