Municipal bonds: the road ahead

Fears of a broad credit crisis in the municipal market have been stoked by the media, spooking many investors into steering clear of the asset class. And while credit risk in the municipal sector exists in some situations, Wealth Management Research–Americas (WMR) does not view this risk to be anything near the dire levels often presented in media reports.

“Despite well-publicized fiscal challenges facing state and local borrowers, vanishing municipal bond insurance and bouts of volatility in bond prices, we continue to view municipal credit as a fundamentally sound, defensive and attractive sector,” says Brad Gewehr, WMR’s Head Macro and Fixed Income. “We expect some credit rating deterioration and, among high-yield issues, an uptick in default rates, but we believe that fears of a broad credit crisis in the municipal market are unfounded. The majority of high quality borrowers in the municipal market continue to exhibit a very strong ability to meet obligations to bondholders, in our view.”

Muni confidence: shaken and stirred
Municipal bonds have long been perceived to be among the most creditworthy of all fixed income assets. Since mid-2007, however, a number of events took place that rattled muni investor confidence: subprime exposure and portfolios of mortgage-backed securities led to insurer downgrades; Lehman’s bankruptcy filing and the subsequent market turmoil resulted in a rapid muni sell-off; and the eventual recession brought about a steep decline in municipal income and sales tax receipts. As the sense of crisis faded, Gewehr explains, investors reentered the municipal market, initially drawn by unusually low prices on high-grade securities. During 2009, resurgent demand for munis led to a strong rebound, but the loss of bond insurance and lingering credit concerns continue to weigh on the market.

In WMR’s view, predictions of a municipal bond market “collapse” are based on misguided comparisons of munis to corporate (and sovereign) debt, but differences abound. For example, studies showed that, over a 15-year period, the average cumulative default rate for ‘A’-rated U.S. corporates is 3.34%, but for comparable municipal bonds, it’s just 0.11% (see chart on next page). Another difference is that municipalities have the authority to raise taxes and fees to service debt. Also, while failed corporations may vanish, with their assets sold and debts extinguished, municipal governments never meet that end.

Although WMR analysts indicate that municipalities will continue to face fiscal stress, as their recoveries typically lag the economic recovery by a year or more, they expect the majority will continue to avoid serious credit deterioration.

Rising rates and potential offsets
Many investors buy muni bonds for the tax-exempt income they provide and hold them to maturity. However, investors need to be informed of the potential sensitivity of prices and total returns on munis to interest rate changes. Rising yields could easily generate negative returns on munis across the yield curve.

WMR forecasts that Treasury yields will begin to rise later this year as economic recovery continues and the Fed begins to reverse its accommodative monetary policy. However, several factors may mitigate the impact of rising Treasury yields on tax-exempt municipal bond prices:

Taxes set to rise for higher-income taxpayers. State and federal marginal income tax rates are expected to rise, boosting taxable-equivalent municipal yields and supporting prices. Longer term, there are other potential tax increases on the horizon, which are generally supportive to muni bond
prices, i.e. higher tax brackets translate into higher tax-equivalent yields (TEYs) on municipal securities. For example, the TEY on a 4.00% tax-free muni rises by close to 50bps from 6.15% to 6.62% under a higher 39.6% tax bracket. If state taxes are considered, TEYs would be even higher for in-state double tax-exempt bonds.

Reduced tax-exempt supply. The launch of Build America Bonds (BABs)—a new class of taxable municipal securities—in April 2009 has had a significant impact on the muni market, particularly on supply. BABs were established as a new financing vehicle to allow municipal issuers to sell taxable bonds and benefit from a direct 35% federal subsidy in lieu of tax exemption on interest.

With BABs taking roughly 30% of total supply, the resulting scarcity of tax-exempt paper has buoyed muni prices, particularly for long-dated bonds. A reduced subsidy will likely diminish the share of BABs relative to tax-exempts beginning in 2011. WMR expects BAB issuance to escalate in the fourth quarter of 2010 as issuers will likely rush to take advantage of the 35% subsidy. In WMR’s view, this potential surge in supply should create a buying opportunity for BABs at year-end. Over time, a broader investor base should improve liquidity and help normalize some of the pricing anomalies between corporates and BABs, as well as bring pricing between taxable munis and tax-exempts more in line with the breakeven point.

Potential narrowing of credit spreads. Finally, yield spreads between ‘AAA’-rated municipals and lower-rated bonds remain significantly wider than historical averages, suggesting the possibility that narrowing spreads could absorb some rise in yields and may help munis outperform Treasury bonds. The strongest demand remains for high-grades, leaving levels on bonds rated below ‘AA’ cheap relative to history. WMR analysts think there is room for muni credit spreads to eventually tighten but do not expect them to match pre-crisis levels in a post-insurance world. They anticipate improvements to lag corporate bond spreads, as historically has been the case during economic recovery.

Let’s talk about it
The above is based on the UBS WMR Risk Watch report: Municipal bonds: the road ahead (March 2, 2010). To obtain a copy of this report or discuss how its research insights might bear on your portfolio, please contact a UBS Financial Advisor.