A Challenging Environment

Similar to other periods of dramatic weakness that we have witnessed in the tax-exempt market over the last six months, de-leveraging is once again the culprit. Several Arbitrage Funds of large money center banks and broker-dealers have gotten the proverbial “tap on the shoulder” to close-out their trades. With their capital base eroding due to asset “write-downs” the banks can no longer carry the same level of positions on their balance sheets. With no option but to sell securities, these entities are being forced to raise cash in the more liquid markets (i.e. municipals). This wave of selling pressure has caused investors to bid at more relaxed prices as they are uncertain when the next round of dealer liquidations may occur.

Traditional hedge funds have also engaged in reducing their municipal bond positions. An extraordinary period marked by rising tax-exempt yields and declining Treasury bond rates has left hedge fund managers with astonishing losses. Said differently 10-year “AAA”-rated municipal bond yields are now higher than they were last summer when the 10-year Treasury bond yield peaked at 5.32%.

The distinction to be made here is that the back-up in tax-exempt yields can largely be attributed to a de-leveraging and not to a heightened concern that municipal issuers will default on their debt. The speed at which the leveraged players have been reducing their holdings has caused yields on 10-year municipal securities to climb by 75 basis points over the last 6 weeks. It is precisely during challenging times like these that a disciplined and methodical approach should yield long-term positive results.

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