It's All About the Flows: 9 / 8 / 2009

Technical forces

The powerful tax-exempt bond market rally has extended its gains into the third quarter primarily driven by two major factors: Incredible new money flows into the mutual funds which have created an insatiable appetite for bonds in the thirty year maturity range, and sparse new issue supply. In particular, the introduction of Build America Bonds (BAB's) by state and local governments has meaningfully reduced the pace of tax-exempt issuance with some municipal borrowers electing to raise funds in the taxable bond market.

Under the BAB's program, issuers receive a subsidy for 35 percent of the interest expense if they elect to issue taxable bonds to fund infrastructure projects. With new-issue tax-free supply curtailed and demand quite robust, thirty-year bond yields have declined at an accelerated pace compared to shorter maturity bonds. Specifically, since June 30th, 2009 the total rate of return of 30-year bonds (+7.55%)[1] virtually lapped the impressive return offered in the 15-year maturity range (+4.64%)[2].

Looking ahead

With new-issue supply expected to expand in the fourth quarter, and select benefits from investing further out the yield curve already realized, we are considering harvesting some capital gains by exchanging a portion of our holdings in the 15-year range and re-allocating the proceeds in the 10-year maturity segment. Or, instead, we may elect to reinvest the proceeds in the same maturity range but just acquire a bond with a shorter call date. The execution of this partial portfolio restructuring will also be driven by other factors: the relative attractiveness of Municipal bonds compared to Treasury bonds, the slope of the tax-exempt yield curve (difference between long and short maturity bonds), the expectation for new-issue supply, market liquidity, and capital gains taxes. Lastly, we will seek to reverse this strategy when we believe we are more adequately compensated for being positioned further out the curve.

Sincerely,
Robert S. Waas

[1]As measured by the 'Long Bond' segment of the Barclay's Capital Municipal Bond Index from 6/30/09 thru 9/4/09.
[2]As measured by the '15-year' segment of the Barclay's Capital Municipal Bond Index from 6/30/09 thru 9/4/09.