Municipal Market Recap: February 2008

Municipal bonds experienced their worst week ever as hedge funds and bank portfolios were forced to sell positions due to capital constraints. Almost every day last week, these leveraged players put billions of dollars of bonds out for competitive bid, and flooded the marketplace with supply. Historically, this event would not have caused major market dislocations as the broker/dealers would have viewed this forced selling as an opportunity to enhance their risk positions using their firm's capital.

Unfortunately, the broker/dealer community ("the street") was already in a weakened position to bid bonds due to their own balance sheet constraints. In essence this is a supply to demand imbalance, as liquidity was scarce and securities were being dumped onto the market forcing yields dramatically higher. This is certainly one of the worst periods that I can recall as the tax-exempt market was down in excess of (-4.50%) using the Lehman Brothers Municipal Bond Index as a proxy, topping the (-3.50%) loss recorded in July 2003.

While no one has a crystal ball to know when the selling pressure abates, there is some reason to be optimistic about the supply-to-demand imbalance becoming restored. In fact, on Friday the tax-exempt market found some new sources of liquidity. I am hearing that approximately $4 billion securities traded to a variety of opportunistic buyers, including taxable total rate-of-return bond funds. This week approximately $8 to $10 billion of new municipal issuance will be priced, and should provide us with insight as to the depth of the demand in the marketplace.

The last month was certainly a painful one to be a municipal bond investor. However, where appropriate, we are using this tumultuous period as an opportunity to reposition our holdings and take advantage of the market dislocations. Increasing cash flow and acquiring bonds that could exhibit an enhanced risk to reward from this new level of interest rates are just some of our goals. Of course in the process we will also be converting some of the unrealized losses to realized losses. This will provide us with added flexibility to realize capital gains when the market rebounds.

Looking back over the last 25 years, there have been other periods of tumult in the municipal bond market. Those volatile times however were marked by fundamental causes such as rising interest rates or the fear of a flat tax. I recall that in March 1986 Packwood rolled out a flat tax plan with Forbes proposing a similar one in 1995. In those instances tax-exempt yields climbed to 105% (using 30 year bonds as a proxy) of treasury securities. In contrast, this environment is unique since there is no meaningful diminution of the issuers ability to repay principal and interest, sharply rising interest rates, or the talk of lower tax rates. It has predominately been the technical forces themselves that have presented investors with an opportunity to acquire high quality municipal bonds at levels that are in excess of the days of the flat tax scare.

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