Municipal Market Update 10/15/08

As of last night, the rout in the municipal bond market has continued unabated.

Why are market prices falling on tax-exempt bonds? For years the purchaser of municipal bonds had been the individual investor. Over the last 15 years however, other types of investors have also emerged; namely, leveraged investors. Whether closed-end bond funds or hedge funds, these entities use borrowed monies to acquire tax-exempt bonds. Their goal was to earn the yield differential between their borrowing costs (short maturity obligations) and their longer-maturity bond investment. As long as short-term interest rates stayed below longer-term interest rates they have traditionally stayed the course and maintained their positions. This is not where we are today, however.

Until now, the traditional “real money” investors have co-existed with the leveraged crowd, but this time is different. Several weeks ago, as the level of short-term interest rates spiked higher, losses were inflicted on the “leveraged community” as their financing cost exceeded the rate of interest on their long-term municipal bond. In order to stave off further losses they headed for the exits in droves. Simply put, the problem is that these motivated sellers are seeking to sell an abundance of bonds that dwarfs the capital base of the broker/dealer municipal bond trading desks. This has created a buyer versus seller imbalance the likes of which we have never seen. Similar to the housing market, the price set by an extremely motivated seller is the new benchmark (“comparable”) for the next transaction.

With the broker/dealer community nervous about the next round of selling pressure, they are showing a heavily discounted price when they are bidding for bonds. This has caused the bid to ask spread (the difference between the value of the bond and what someone pays) to widen dramatically. Currently, when a bid does emerge, the differential between what we think a bond is worth and the actual price a buyer will pay can be as much as 5 points (5%).

While it is very rare to see these periods where the municipal asset class has been under so much stress, what is unique this time is the speed of the price erosion. The market did experience a similar episode in 1994. Here to, was a period marked by a de-leveraging which occurred in the Treasury market but spilled over into the tax-exempt market. That episode caused 10-year municipal “AAA”-rated yields to rise by 135 basis points (1.35%), similar to the 117 basis point rise experienced this year.

Where are we now? While no one should be comfortable with this type of yield spike, every investor now has to ask him or herself one basic question. Do you judge an asset class during times of nearly unprecedented price volatility or remain committed to an asset class that over time has produced solid returns relative to the taxable market? If you analyzed the municipal bond asset class in 1994 instead of 1995, your opinion would be vastly different. Here, yields plummeted by approximately the same amount that they rose in 1994.

Let’s talk about the 800 pound gorilla

Even though many investors understand the liquidity and related issues discussed above, some believe that this is all about the increased risk of default. While we have steadfastly believed that the fiscal health of many municipalities is under pressure and should result in an increased incidence of credit rating downgrades, the event of actual default will remain relatively low for higher quality issuers.

The bottom-line: The market lacks a sense of order and is often missing the necessary liquidity to try to exchange one bond for another or raise cash. As order is restored to the market, we can better begin to function efficiently again, focusing on the necessary repositioning that hastens the speed of recovery. Furthermore, although invested in an asset class that is second only to the U.S. Treasuries in terms of default risk, we are continuously monitoring the credit worthiness of our holdings and related events.

Some investors may be giving the market too much credit at predicting future events. Sometimes the price volatility is just what it seems as in this case. Too many forced sellers trying to fit through a tiny door at the same time.

Sincerely,

Robert S. Waas
Managing Member

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