Municipal Market Update (11/30/16)

Since the Presidential election (through last night), Ten-year maturity Treasury bond yields have jumped 43 basis points, rising quickly from 1.86% to 2.29%. During this same time period, municipal yields have risen at an unusually disproportionate rate, as tax-exempt Ten-year yields stood at 2.45%, rising 74 basis points from 1.71%. The weakness in the tax-exempt universe is reflected in the total rate of return of the market's "yardstick", the Barclays Capital Municipal Bond Index, which was down 3.54% over the same time period.

Unfortunately, conditions in the municipal market remain disorganized. The dislocation has primarily been caused by mutual fund portfolio managers who have been forced to sell bonds to meet investor redemptions. This has come at a time when the broker/dealer community has been reluctant to add risk to their trading inventories. As is typical, the supply and demand imbalance has caused widening bid-to-ask spreads (the difference between the value of a bond and what someone is willing to pay).

One way to measure how extreme the move has been in the municipal bond market is by referring to the municipal to Treasury yield ratio (Municipal Bond Yield/ Treasury Yield). This ratio indicates how "cheap" or "expensive" municipal bonds are valued, in relation to Treasury bonds. Currently (as of close of business 11/29/16), the municipal to Treasury ratio stands at 106.9%, meaning that municipal bonds were yielding 106.9% of Treasury bonds. To put today's ratio into perspective, over the past 27 years (since 1990), we've only seen this ratio exceed today's levels 3.6% of the time. In short, rather than investors paying for the tax exemption by earning lower relative yields, currently the bond market is compensating investors to earn tax free yield.

One type of transaction that RSW is currently engaged in (where appropriate) and that clients may benefit from is "tax loss selling". This is accomplished by strategically selling bonds below their cost basis to "lock-in" a "tax loss" that can be used to offset any realized or future capital gains. The proceeds from these sales are then typically reinvested in bonds with similar investment characteristics and higher yield levels than the original purchase yield of the bond sold. These higher yields are a product of the recent backup in market rates that we have been writing about. By "harvesting" tax losses, the market value of the portfolio should not be impaired due to this transaction as we are merely converting unrealized to realized losses. Of course, we are always diligent in considering the execution costs (bid-to-ask spreads) before engaging in these transactions.

As always, we'll continue to keep you posted.

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