Municipal Bonds Afford Uncommon Relative Value

In the last 12 months, the de-leveraging forces that began in the taxable bond market spilled over into the tax-exempt arena. Forced selling became a byproduct of the deteriorating financial health of the monoline insurers. As the "AAA"-rated veil was pierced, investors who needed the "AAA"-rated label were forced to exit their positions. In addition, Arbitrage accounts and other leveraged players were pressured by balance sheet constraints which forced municipal yields to decouple from their Treasury brethren. Lastly, a lack of liquidity was caused as some larger firms exited the Institutional marketplace.

Where are we now?

- The ratio of tax-exempt bonds relative to Treasury securities is relatively high. For example, 10-year "AAA"-rated tax-exempt securities can be purchased at yields that are roughly equivalent to Treasury yields. Bottom line: a 3.70% 10-year tax-exempt bond carries the taxable yield equivalent of a 5.69% (Using the 2008 maximum tax rate of 35%).

- The steepness of the municipal yield curve inflicts an outsized penalty for holding cash. For example, the yield on 7-day tax-exempt securities currently stands at 1.84%. In other words, the base rate or gross rate of short-term yields is just that: unacceptably gross!

- One of the byproducts that has resulted from the implosion of the financial guarantors is wide credit quality spreads. For example, the yield differential between "A" and "AA"-rated bonds relative to "AAA" has widened markedly. For investors whose assets are currently deployed in municipal bonds, this is a negative event. However, individuals looking to add additional funds or new investors seeking to commit funds can become the beneficiaries of the credit spread widening.

Looking ahead, there is the potential for credit quality spreads to narrow. As S&P, Fitch, and Moody's recalibrate their tax-exempt ratings to be more in line with their "global" ratings criteria, roughly 95% of the market will become "AA" and "AAA"-rated. This could cause the yield differential between lesser quality and "AAA"-rated bonds to narrow.

Sincerely,
Robert S. Waas
Managing Member

RSW Investments, LLC • 47 Maple Street, Suite 304 • Summit, NJ 07901-3647 • (908) 608-9600
www.rswinvestments.com