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Municipal Market Update: 8/29/07

The current financial market upheaval has caused investors to rush into the Treasury market and despite the rally, this particular “flight-to-quality” episode has seen Municipal bond yields actually rise. Why has this occurred? With brokerage firms experiencing losses in their most risky holdings, Municipal bond traders were tapped by management to sell the firm’s most liquid non-Treasury investments in an attempt to “free-up” cash. Unfortunately, this selling pressure caused some investors to behave irrationally as they chose to liquidate positions. This action put further pressure on a market that was experiencing a “buyer’s strike” from individuals, as they have been virtually sidelined by the extreme market volatility.

“Non-traditional” market participants have also exerted upward pressure on tax-exempt yields. While it is true that individuals remain the dominant investors in the Municipal bond arena, the number of leveraged players, such as hedge funds, has quickly and quietly escalated. Here too, in the tax-exempt market, these entities fly under the radar until periods of extreme volatility. As is often the case, irrational fear creates rare opportunities because as quickly as the selling emerges, it often tends to disappear. In fact, we are already seeing signs that this is beginning to occur. It is important to be mindful that this event was not driven by concerns about Municipalities’ ability to make their principal and interest payments. In addition, it was not driven by a perceived weakening of the claims paying ability of the Insurance companies who guarantee Municipal obligations. In our view, it was simply started by brokerage firms who needed to increase cash reserves on their balance sheets and made worse by Hedge Fund’s who need to reduce their leveraged positions.

Where do we go from here? With Tax-exempt yields approaching the same level as Treasury yields, demand for municipal bonds is beginning to normalize. For example, a number of professional money managers are shifting assets to the municipal bond market as they commit funds based on historically attractive relative yield levels. We have witnessed these “cheaper” relative valuations in the past, and we believe that this is a unique long-term investment opportunity. After all, if you are paying a 35% Federal tax rate, you are supposed to say thank you very much for the recent bout of Municipal bond price weakness, and concentrate your attention on the market’s relatively high taxable equivalent yield and strong credit quality. For example, 10-year “AAA” –rated Insured tax-exempt bonds are now offered at 4.19% (6.54% taxable equivalent yield¹) compared to like maturity Treasury debt which can currently be purchased at a yield of 4.56%.

¹Based on a 34% maximum Federal tax rate.

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