It's Go Time

Munis offer bargains at year-end

By Jim Reber

If your holiday gift list includes some high quality investments with limited price volatility, good liquidity and, oh yes, high yields, this column is for you. Your friendly state and local governments are likely to roll out some gift-wrapped offerings for even the most discriminating of investors. But time is of the essence.

Fixed income markets in general, and the municipal market in particular, have had a wild ride in the last 12 months alone. The muni market's volatility was in large part created by an unlikely source: Meredith Whitney, the analyst who last December brazenly predicted "hundreds of billions of dollars" of defaults in 2011. Through nine months of this year, total defaults have not yet reached *one* billion. Muni interest rates skyrocketed as soon as her comments hit the media.

Other factors at play

Ms. Whitney's comments aside, the muni market was already suffering from a state of indigestion thanks to Congress. The main 2009 stimulus bill, the ARRA, contained several provisions that greatly increased the supply of munis in late 2010.

One was the creation of a taxable muni known as a Build America Bond. The purpose of BABs was infrastructure improvements, but the catch was they had to be issued before December 31, 2010. A total of $187 billion made it through the cattle gates before they were padlocked. Others were the "2 percent bond" and the "AMT exempt bond." These two are similar in that they too had to be issued by 12-31-10, and have features that can offer superior value to garden variety bank-qualified munis.

Finally, another provision that sunset was the annual dollar limit on an issue for it to be considered bank-qualified. Between 1986 and 2008, that number was $10 million. For the two subsequent years, it was raised to $30 million. We are now back to the pre-2009 limits.

Since it was clear the door was closing by December of last year, the muni mill was working three shifts. Huge supplies of all the above were being churned out, and in fact 2010 set a new standard for total issuance of all municipal debt. The deluge simply could not be handled by the investing public, and what had to give was prices. That, along with Ms. Whitney's haymaker, meant bargain time for patient investors.

2011 gyrations

The current year has seen the corollary. Supplies have greatly been limited: total new bank-qualified issuance through October has been $14 billion, whereas $38 billion was raised last year. Defaults are running well behind recent experience, and banks remain flush with cash, so yields have gradually declined (i.e., prices have risen).

The good news is that munis remain a bargain by almost any yardstick. A ten-year AA-rated General Obligation muni as of this writing has a tax-free yield of about 125 percent of the benchmark 10-year Treasury. The "normal" relationship is about 85 percent. That advantage escalates when the taxequivalent yield formula is put in place. Add to this the resiliency of the steep curve, and you have some built-in protection against rising rates.

Remember December

Things should get better for investors between now and year end. There is every expectation that yields will rise as, once again with feeling, muni issuers rush to the window to get debt booked by December 31, so as to comply with the $10 million per year limits. Keep in touch with your brokers, and keep some powder dry, to take advantage of the higher yields.

If you are able to go holiday shopping for bargains munis, remember to expand your wish list to include bonds other than bank-qualifieds. BABs and "2 percent bonds" can be found with a little bit of comparison shopping. Keep in mind that January 1 is by far the biggest date of the year for maturities and calls for municipals, so you may be able to replace some of your current holdings a few days early, and beat the rush.

Belt tightening in January

Good news of a different manner is likely to occur in January. As the December supply gets worked out, there is very little new supply in January, for the exact same reason as there is a year-end crush. Lack of supply equals rising prices. So don't be surprised if January proves to be a seller's market.

Be sure to consult with your brokers and tax accountants before selling any munis though. Whether they have losses or gains, the tax-free nature of them requires careful analysis to make sure any transactions achieve full market efficiency.

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