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Muni drought looms after December’s flood

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After December's record breaking storm of issuance, a period of calm may be on the horizon for municipal bond investors in 2018.

Supply surged to $57.89 billion this month — a record for December — as issuers rushed to compensate for the possible elimination of some types of tax exempt bonds as part of the overhaul being hammered out in Washington.

Though the final tax bill taking effect after Dec. 31 preserved the use of private activity bonds and governmental use bonds for professional sports stadiums, it eliminated the use of advance refundings. It also left buyside strategists scratching their heads over whether issuers had enough supply left to meet demand in the coming months.

“If December 2017 is the all-time record for municipal bond issuance, will the first half of 2018 be the all-time low?” asked David Tawil, president of Maglan Capital.

“A scarcity of supply could result in stronger demand and tighter spreads generally,” said Jeffrey Lipton, head of municipal research and strategy at Oppenheimer & Co. said. “A particular shortage of certain types of bonds could alter the performance dynamic for outstanding bonds within those sectors.

“Rates, curve positioning, the universe of currently refundable bonds and an outlook for the economy in general — and for municipal credit specifically — will all influence supply patterns in 2018,” Lipton said.

Overall, buy-side experts said an evolution of the municipal market is on the horizon.

“Going into 2018, tax-reform, even a watered-down version, would alter muni market dynamics,” Lipton said in an interview before the bill was completed. “We see a very constructive technical landscape taking shape for early next year,” he continued.

“While a lower individual tax rate structure would not be expected to impact muni demand and valuations, a significantly reduced corporate tax rate of 20% — or possibly 21% or 22% — may influence institutional demand and may produce a modest repricing of the tax-exempt yield curve,” Lipton added.

The bill signed Dec. 22 by President Trump will lower the corporate tax rate to 21% from 35%.

However, tax reform won’t deter municipal investors from being active in 2018, experts said.

“We believe that demand for the asset class will hold up and we see good overall performance,” Lipton said.

John Mousseau, director of fixed income at Cumberland Advisors, said increasing yield ratios influenced investors in 2017 and will continue to do so in the months ahead — provided muni-to-treasury ratios remain attractive.

Ten-year municipals are currently yielding 84.4% of the yield of comparable Treasuries, while the 30-year municipal benchmark is yielding 94.4% of the 30-year Treasury as of Dec. 22, according to MMD. The ratios in 10 and 30 years have been as high as 98.5% in 10 years and 103.5% on the 30-year in the last 12 months.

Rick Calhoun of Crews & Associates said investor’s recent strategy of buying longer bonds could change in 2018 as the yield curve continues to flatten, though tax payers will still be influenced to heavily invest in tax-free securities.

“It appears that investors in higher income brackets may actually see their taxes go up and higher taxes may increase municipal bond demand,” Calhoun predicted.

Issuers will also be impacted in a big way in the coming year, according to the experts.

“An inability for issuers to rely on advance refundings as an effective debt management tool may diminish financing flexibility for those borrowers who already have limitations,” Lipton said.

“The question for 2018 is whether any entity – city or state -- will achieve meaningful pension reform,” Tawil of Maglan said. The type of federal hurricane relief provided to Puerto Rico and the U.S. Virgin Islands will also set an important precedent for forthcoming distressed municipal situations — “if existing debt is primed by a federal loan.”

Others turned their attention to credit risk in the New Year.

“Given our position that municipal credit quality has plateaued, we are very much concerned over any development that could adversely impact future credit quality,” Lipton of Oppenheimer added.