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US taxable municipal bonds: Still an opportunity

Greg Gizzi
Senior Portfolio Manager

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International buyers now hold 40% more in municipal bonds then they did at the end of 2012 (source: US Federal Reserve). While first-quarter 2018 data suggests a slight reversal in foreign interest, US taxable municipal bonds continue to deliver attractive relative returns compared to US corporates, due to technical factors like reduced supply stemming from US tax reform.

While taxable municipals remain an attractive risk-adjusted alternative for many non-US institutions, an improvement in hedging costs is likely required before we might expect to see any up-tick in demand in the near term. However, the municipal asset class continues to represent an opportunity for global investors focused on long-term liabilities. The asset class offers the potential to obtain diversification with good-yielding, high-quality, long-duration assets, and in the case of the EU investors may also receive preferential capital treatment based on current regulation.

The most recent US Federal Reserve data released for the first quarter of 2018 showed that foreign buyers reduced municipal holdings by $US1 billion and now hold $US100.5 billion in municipal debt. This represents 2.6% of the overall municipal market. This was the first time in more than five years that international investors reduced municipal holdings. Despite this decrease, international buyers now hold 40% more holdings in the municipal asset class then they did at the end of 2012 (source: US Federal Reserve).

In our view the reasons for the downtick can be attributed to profit taking on rising rate fears or better relative value in the US investment grade (IG) credit space. But the overwhelming factor that has tempered international demand for municipal assets has been the increasing cost of currency hedging. International investors, European entities in particular, have slowed flows into the space due to unfavorable hedging costs. Interest rate differentials have not sufficiently offset the increased hedging costs resulting from movements in LIBOR and the resulting impact on swap spreads.

Returns remain relatively attractive

From a relative performance perspective, the asset class has done quite well against its US IG corporate counterpart. If we examine the year-to-date return of the Bloomberg Barclays Taxable Municipal Bond Index compared to the Bloomberg Barclays US Corporate Investment Grade Index ending June 30, the Taxable Municipal Bond Index has outperformed the US Corporate Index by 226 basis points, returning -1.01%. If we consider the fact that the municipal asset class is a longer maturity asset class, when we compare the Long Only Bloomberg Barclays Taxable Municipal Bond Index to the Long Only Bloomberg Barclays Investment Grade Corp Index, where “long” is defined as 10+ years in maturity, this dispersion is even larger. Long taxable municipals outperformed by 540 basis points, returning -1.37% versus long US credit at -6.77%. This type of outperformance was not unexpected from our perspective.

Heading into 2018, our outlook was for municipal spreads to be more resilient than US credit spreads due to expected solid supply/demand technicals. Through the first half of 2018, this is exactly what has materialized.

On the supply side, taxable municipal issuance is down approximately 29% year over year* (source: JP Morgan, Bond Buyer). This contrasts with the US credit market, which has IG corporate supply down approximately 3% year over year, which is off a record $US1.37 trillion in new issue supply in 2017 (source: Bank of America Merrill Lynch).

On the demand side, while international inquiry for taxable municipals has been sporadic, there continues to be consistent demand from US investors. There has also been very limited selling of the asset class during the first half of the year.

The resulting impact from lower supply and solid demand has been significant spread outperformance. If we compare the spread movement, using the option adjusted spread (OAS) of the Bloomberg Barclays Taxable Municipal Bond Index with the OAS of the Bloomberg Barclays US Corporate Investment Grade Index, taxable municipal OAS has tightened approximately 7 basis points while US IG corporate OAS has widened approximately 29 basis points.

While we were expecting lower aggregate supply in 2018 for the municipal asset class, we expected taxable issuance to be higher, while the impact of tax reform and the subsequent "pull forward" of tax- exempt supply into 2017 would lead to lower tax-exempt supply. A significant increase in infrastructure spending, the catalyst for an uptick in taxable municipal supply, has yet to materialize. This can be partially attributed to a lack of progress on a federal infrastructure program in the US Congress. There are, however, a few proposals before Congress this summer: The Generating American Income and Infrastructure Now (GAIIN) Act (US House of Representatives Resolution 6104), the Water Resources Development Act of 2018 (WRDA) authorizing Army Corps of Engineers civil works activities (HR 8), and the Federal Aviation Administration reauthorization (US Senate Resolution 1405). It will take a substantial increase in infrastructure spending to significantly elevate the taxable municipal supply run rate.

Outlook

Despite recent improvements in hedging costs, we believe there is still progress to be made before the spigot is fully turned on again, especially from European investors. While taxable municipals remain an attractive risk-adjusted fixed income alternative, inquiry from international investors has been sporadic and the outperformance of the municipal asset class has made US credit relatively more attractive than it was a year ago. The supply opportunity in US credit markets certainly steers trading-oriented investors to favor that asset class in the current market environment.

From a longer-term perspective, we remain confident that the increasing demand for the taxable municipal asset class experienced over the last five years will continue. We believe this trend should only increase in magnitude if supply accelerates. The municipal asset class continues to represent an opportunity for global investors focused on long-term liabilities to obtain diversification with good-yielding, high-quality, long-duration assets, which, in the case of the European Union, may also receive preferential capital treatment from regulators under the Solvency II directive.

*Includes both municipal and corporate CUSIP issuance.

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Index definitions

The Bloomberg Barclays Taxable Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term taxable municipal bond market.

The Bloomberg Barclays US Corporate Investment Grade Index is composed of US dollar–denominated, investment grade, SEC-registered corporate bonds issued by industrial, utility, and financial companies. All bonds in the index have at least one year to maturity.

The Bloomberg Barclays Long US Government/Credit Index is composed of publicly issued investment grade corporate and US government debt securities with maturities of 10 years or more.

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