THE OMNIVEST MARKET VIEW

Investments

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No Bond Bubble in Munis

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BBB munis yielding north of 4.00% (on a pre-tax basis) are trading at a far distance from what anyone might consider to be a bond bubble. Fixed income investors seem paralyzed due to ultra-low Treasury yields and numerous predictions of an eminent bond bubble. As a result, the low quality segment of the muni market has yet to be recognized as offering excellent value.

Factors such as rising unemployment, declining state revenues from retail sales taxes, lower property taxes and lower income tax revenues have all helped to create real fears about the deterioration of municipal credit quality.

From our perspective, these fears were well respected in 2008, post the Lehman Brothers collapse. We are now 4 years past that trying time period and most of these same fears have either stabilized or have started to improve. Nonetheless, a 4.65% yield for a BBB muni compares quite favorably to a 3.40% yield for a BBB corporate. Also, these yields are on a pre-tax basis, which further underscores the fact that municipal yields remain quite high in an otherwise very low yield environment.

Regardless of one's tax bracket or tax status (exempt or otherwise), lower quality munis can aid in filling the yield gap that has been created from Quantitative Easing. The positive yield spread between low quality munis and equal quality corporate debt (a condition that has persisted for nearly 3 years now) appears to be narrowing.

Since the start of 2013, BBB rated munis have gained 1.4% in total return versus -0.25% for BBB corporate securities and -0.96% for Treasuries (Merrill Lynch data). And while 3 months does not make a trend, these data points do suggest that munis are beginning to outpace other fixed income securities.

It is our view that the yields (offered in low quality munis) compensates investors for the risk that munis may lose their tax exempt status. We say this because munis today, generally speaking, clearly out-yield corporate bonds. Historically, the analysis of relative value would have been made on an after tax basis showing that the tax adjusted yield of munis was greater than corporate securities. This analysis is now rendered moot because of the pre-tax yield advantage of munis.

The risk that Treasury yields continue to rise should not hinder investors from investing in municipal debt. The most likely scenario is that Treasury yields rise and municipal yields either fall or remain unchanged over the next 12 - 24 months. It is our base case that municipal yields will actually fall, as has been the case since July of 2012 when Treasury yields (as measured by the 10-year Treasury note) started an irregular rise from 1.38% to slightly over 2.00% today. Muni yields were approximately 4.80% during the same time period and have drifted to 4.65% today.

In summary, we believe that low quality munis appear to have priced in fears that no longer apply given the fundamental improvement in the US economy.

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