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Fourth quarter game plan focuses on duration, protection, and value

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To quench their thirst for yield and position for a rally they believe will occur in the fourth quarter, municipal portfolio managers are using strategies that protect principle, remain defensive against market volatility, and deliver value as the end of 2017 nears.

Phil Fischer, managing director of municipal research at Bank of America Merrill Lynch, said the firm's core strategy is to stay invested and overweight on the long end of the municipal yield curve due to its expectation that the long end will rally amid subdued inflation and a steady tightening cycle by the Federal Reserve Board.

"That is the recipe for curve flattening," Fischer said. "The long end rallies the most, while the short end of the curve changes little."

Fischer said this isn't the first time the firm has been overweight on the long end of the curve — that strategy has been in place since late 2016, he noted.

"The market conditions that have made this strategy work have not changed — and the possibility of intensification exists if there is any deterioration of the economy or external risks," such as other fiscal or political risks, Fischer said.

Federal Reserve Board Chairwoman Janet Yellen in a Sept. 20 press conference said she expects gradual rate hikes to be warranted, but not preset, and said they will stay below the levels of prior decades.

In addition, inflation will be softer this year and next as it comes close to 2% in 2018 and stabilizes at that target in 2020, while the GDP is expected to be slightly stronger than originally expected back in June, according to Yellen.

Ahead of this scenario, other managers are being motivated by the appearance of a rich municipal yield curve and tight ratios and spreads, as well as one-year forward Treasury rates that imply a flattening of the yield curve with range-bound long rates.

To hedge potential downside risk on the short end and preserve income on the long end, Ramirez & Co. will continue to use a barbell strategy for clients in the fourth quarter, according to Peter Block, managing director of credit and market strategy.

The strategy offers clients the benefit of an effective duration of about 10 years, and a 20-year average maturity, the New York City-based investment banking and wealth management firm said in a Sept. 18 weekly municipal.

In the report, the firm said market conditions going into the fourth quarter suggest an opportunity for some accounts to swap out of higher-rated paper with shorter calls into lower-rated paper with longer calls.

Clients can currently achieve this strategy, and pick up between 40 and nearly 70 basis points of yield, by using two different swap possibilities.

In an interview, Block said the firm is recommending some clients sell double-A-rated paper with 10- to 30-year maturities and five- to seven-year calls and buy A-rated bonds with similar maturities and eight- to 10-year calls. By doing so, clients can earn 20 basis points for duration extension and 20 basis points for lower, albeit still strong, credit quality, he said.

Spreads on A-rated paper due in 10 and 30 years are tighter by about 47 and 64 basis points, respectively, versus one-year averages.

“However, the A-rated sector at this time represents the most compelling credit-down swap versus other credit-down trades,” such as single A to a triple-B trade or triple-B to a high-yield credit, according to the report.

The credit down trade can also be achieved by swapping Connecticut general obligation bonds for University of Connecticut GO paper, for instance, to pick up an extra 65 to 67 basis points on 10-year paper, Block noted.

“UConn GOs are unsecured university obligations and should over time outperform state of Connecticut,” the Ramirez report stated.

Meanwhile, quality and portfolio diversification are two essential strategies for absorbing potential market volatility that could arise from political, economic, or market shocks in the upcoming fourth quarter, according to Jeffrey Lipton, managing director, head of municipal research and strategy and fixed income research at Oppenheimer & Co. More specifically, he recommends owning premium bonds because their larger coupons offer a cushion from adverse price performance in declining markets.

“Premium bonds can offer maximum tax-free income and high cash flow, higher yield to maturity and yield to call than bonds priced at discounts or close to par, and less secondary market price volatility,” Lipton said.

Like his colleagues, he also suggests extending to 20-year maturities where clients can earn 90% of the yield on the municipal curve.

As of Sept. 28, the generic, triple-A general obligation scale in 30 years yielded 2.85%% in 2047, compared with 2.27% a year earlier, according to Municipal Market Data.

Triple-A MMD yields have trended down recently, as the 30-year has been sitting below 3% and the 10-year lower than 2%. The 2027 through 2047 maturities were one basis point higher on May 9 and since then, that range has been either unchanged or lower in yield daily, according to MMD.

In addition, he believes a barbell strategy can reduce reinvestment risk and provide added protection on the short end if rates rise, while locking in higher, long-term returns if rates decline, he added.

"The value trade is even more relevant as we are seeing shifts in risk appetite given geopolitical factors and uncertain fiscal and monetary policy stances here at home," Lipton said. "Add to the mix a run of natural catastrophes and you have all the ingredients for unsettled market conditions, which are testing the risk appetite among investor classes."

Reflecting on the third quarter, Lipton said summer technicals and a widely-held perception that political inertia would delay any progress towards tax reform and general stimulus measures have been supportive of muni bond prices and have contributed to generally positive fund flows and to the year-to-date outperformance of the asset class relative to Treasuries.

"A likely shift in market technicals could soften demand, although we are not convinced that volume will see an appreciable pick-up through year-end," Lipton added.

With year to date volume down approximately 15% from last year, long-term volume totaled $256.70 billion in 7,331 issues as of Aug. 31, compared with $302.85 billion among 9,297 issues over the same period in 2016, according to Thomson Reuters.

Ramirez forecasts net market supply to end 2017 at $38 billion higher than last year, while it estimates long-term new-issue gross supply for 2017 at $368 billion — a decline of about $60 billion, or 14% from last year, the firm said in its report.

At the same time, there may be some opportunities from market volatility as the year wraps up, Lipton of Oppenheimer noted.

He said there is a possibility that the tax reform debate could heat up before year end and increase concern over the current tax benefits provided by municipal bonds. This could generate some "intermittent volatility through year-end as prospects for lower taxes are weighed against implications for future muni demand and valuations," Lipton said.

"We think that fiscal policy-driven volatility could present buying opportunities and investors should pay attention to upward shifts in yields and relative value ratios as perceived threats to the asset class take hold," Lipton suggested. "We maintain that demand should hold in under anticipated scenarios of lower individual and corporate tax rates, yet rhetoric surrounding its elimination can add to market volatility."

Others, meanwhile, said they plan to maintain strategies that generate higher yield income and principle protection.

"Going into fourth quarter of 2017, we will most likely continue to focus on the type of structure we focused on in the past two quarters: higher coupon, cushion bonds," said John Mousseau, managing director of municipals at Vineland, N.J.-based Cumberland Advisors.

Premium bonds, known as cushion bonds, are securities purchased at a price higher than its par value and with a coupon rate that is higher than the prevailing market interest rate. A premium bond can provide less secondary market price volatility than similar maturity bonds selling near par or at a discount. They can also offer higher yield to maturity and yield to call than bonds priced at discounts or close to par – and offer protection in a rising rate environment.

At the end of 2016 and in the first quarter of 2017 Mousseau favored the use of long maturity discount structures with 3% handle coupons and 4% par-like bonds, he said. "As yields came down — and core inflation as well — we realized that issuers would resume the refinancing and pre-refunding activity which dominated the first three quarters of 2016," Mousseau said.

Owning premium bonds in the last three months of 2017 will continue to reap value for his clients, according to Mousseau. "The cushion bond structure provides a greater amount of yield per unit of duration risk, with the added value of appreciation in the case of pre-refunding," he said.

Others, meanwhile, are being cautious into the fourth quarter and beyond due to fiscal and economic concerns and are adjusting their strategies accordingly.

Miller Tabak Asset Management will focus on upgrading credit quality in client portfolios in the coming quarter, said Michael Pietronico, chief executive officer of the New York City-based asset manager.

"We sense the beginnings of a weaker issuer financial profile in the municipal market next year," he said. "While economic growth has remained positive, the potential for a recession sometime next year cannot be ruled out as the Federal Reserve continues to remove liquidity from the financial markets."

Some states, like Illinois, have "burdensome" obligations, according to Pietronico, who said that raises concern that the market may be "too apathetic" about the ultimate repayment of those states' debt.

Unlike his peers, Pietronico said he will avoid premium bonds and stick with discount paper for its relative value.

"We have and will continue to focus on lower coupon bonds as we continue to see them as extraordinarily cheap relative to premium bonds -- especially around the 15-year area of the municipal yield curve," Pietronico explained.

Michael J. Belsky, senior portfolio management director and co-founder of Morgan Stanley's Vector Group, said he remains cautious on municipal bonds.

“We are interested in issues revolving around the Puerto Rico legalities of cashflow seniority between GOs and sales tax bonds, which might throw muni security structures into question,” he said. Belsky manages approximately $1 billion for high net worth clients, small corporations, and endowments, as well as so-called “legacy” clients that are older individuals with low risk tolerance and the need for asset allocation.


Michael J. Belsky

Additionally, he said 10-year relative value ratios have declined to levels he has not seen for two years, and that is keeping him sidelined for now.

“We are waiting for a more-timely entry point,” Belsky said.

The muni to Treasury ratio in 10 years was 86.7% as of Sept. 28, down from 94.6% a year earlier in 2016, and 98.7% at the same time in 2015, according to Thomson Reuters.

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