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Muni Bonds and Rate Volatility

Interest rates go up, prices go down.

Ask any fixed income portfolio manager in the world what the first rule of investing in bonds is and you'll hear the phrase above or something similar. And while the notion that bond prices decline as interest rates increase is not a matter of opinion but math, it is important to remember that bankers have multiple goals when managing the investment portfolio. Aside from price risk, yield or current earnings is a critical factor in the investment equation, now more important than ever as bankers have been fighting falling net interest margins for longer than a decade now. This means actively purchasing municipals regardless of the direction of interest rates. When it comes to recent rate moves, many portfolio managers face two options: do we shorten duration, increase liquidity, and wait for rates to increase or do we stay deployed and even extend duration at times, given the relative attractiveness of yields on the long end of the curve? Below we'll make the argument that the ladder approach is more successful for your bank's portfolio and overall long-term performance of the bank.

- Studies have shown that during periods of rising interest rates, municipal bonds typically outperform Treasuries, especially those with longer maturities. The yield curve usually flattens when the Fed tightens, as short-term rates rise faster than long-term rates. For example, from 2004 to 2006 and 2015 to 2018 the yield curve flattened over 200bps and 50bps respectively; longer-maturity term municipals outperformed Treasuries in both periods. This sort of pricing behavior is modeled in The Baker Group's Baker Bond Accounting (BBA) as well as other fixed income analytics. The chart in this article reflects recent movement in Treasury Yields to Municipals over the last year. The Muni-to-Treasury (M/T) ratio is also a very import metric in evaluating the attractiveness of municipals versus taxable alternatives. The long-term average for the 10Yr maturity of around 85% is currently trading in the low 60s, which illustrates this asset class has held on as rates have risen.

- On the demand side, approximately two thirds of the $4 trillion municipal market outstanding is owned by individuals (through outright ownership or mutual funds). The mom-and-pop investor class has historically favored municipals as buy and hold to maturity investment, producing less volatility in trading supply. Furthermore, higher tax rates on corporations and high net worth individuals from the Biden Administration will spur more demand as Tax Equivalent Yields (TEY's) will increase.

- On the supply side, during periods of rising rates, new issue volumes and refinancing activity will tend to fall due to higher borrowing costs. This supply and demand imbalance tends to keep prices higher. Also, the coupon on municipal securities is often higher when comparing similar maturities of Treasury and high-quality corporates. This is because of underwriting differences that benefit the investors with a more defensive structure.

- Most bank portfolios focus on the tax-exempt side of the market, which include Bank Qualified and General Market issues. Since the 1980s, the BQ carve out has existed. Banks will own both types but have historically favored Bank Qualified (without getting into tax details). BQs are generally more expensive due to the limited supply (< 10% of TE total) and the TEFRA tax advantages. Both of these categories, BQ and GM, experience the stickier prices.

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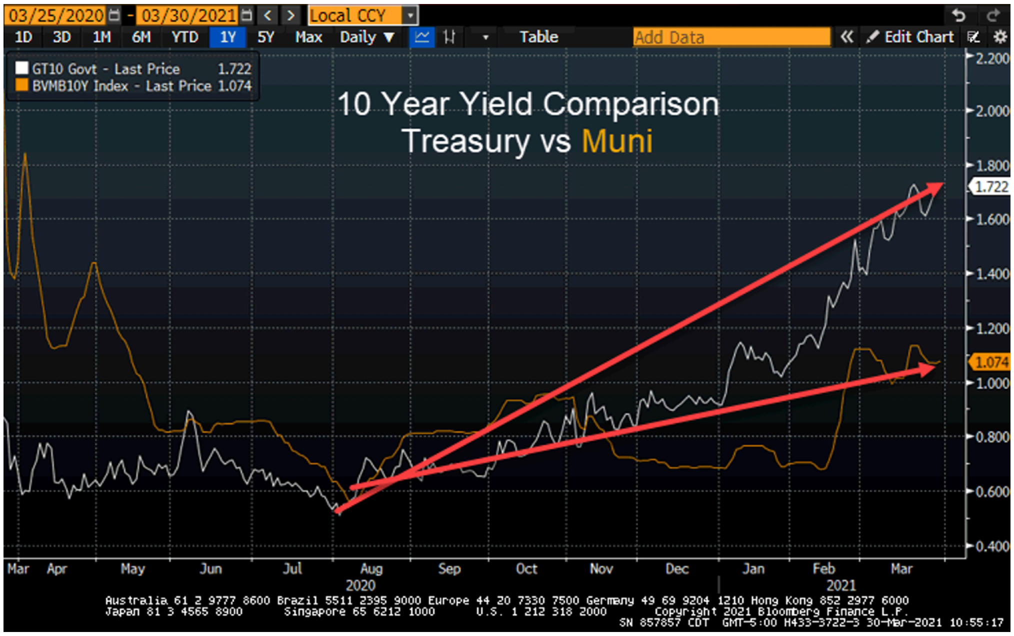

The 10Yr US Treasury yield has increased approximately 60 basis points since the beginning of the year while the municipal index has moved approximately 30 basis points. Source: Bloomberg LP

Banks with high performing portfolios typically assign their highest allocation to municipals versus the other classes. This can be verified through Call Report and UBPR information. That being said, municipals are not the only ingredient for successful a portfolio and should not be held in isolation. Another very important aspect of municipals is the credit risk they carry will always require extensive pre-purchase and ongoing analysis. The Baker Bond Accounting (BBA) system and other bond tools can be used to assist in the ongoing credit analysis reviews.

In conclusion, portfolio managers who were able to purchase longer duration municipals did so knowing they had ample cash flow coming from other parts of the portfolio (agency calls or MBS cash flows for example) even if interest rates were to suddenly move higher. Those investments in higher-yielding, longer term securities made for a good combination as the portfolio yield was anchored higher but still allowed for the consistent deployment cash flows at prevailing market rates. Successful risk managers are keenly aware of the difficulty in prognosticating interest rates, and for that exact reason continue to stick to by their investment policies and strategies that include longer-duration municipals.

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