Municipal Bonds Ride Federal Stimulus

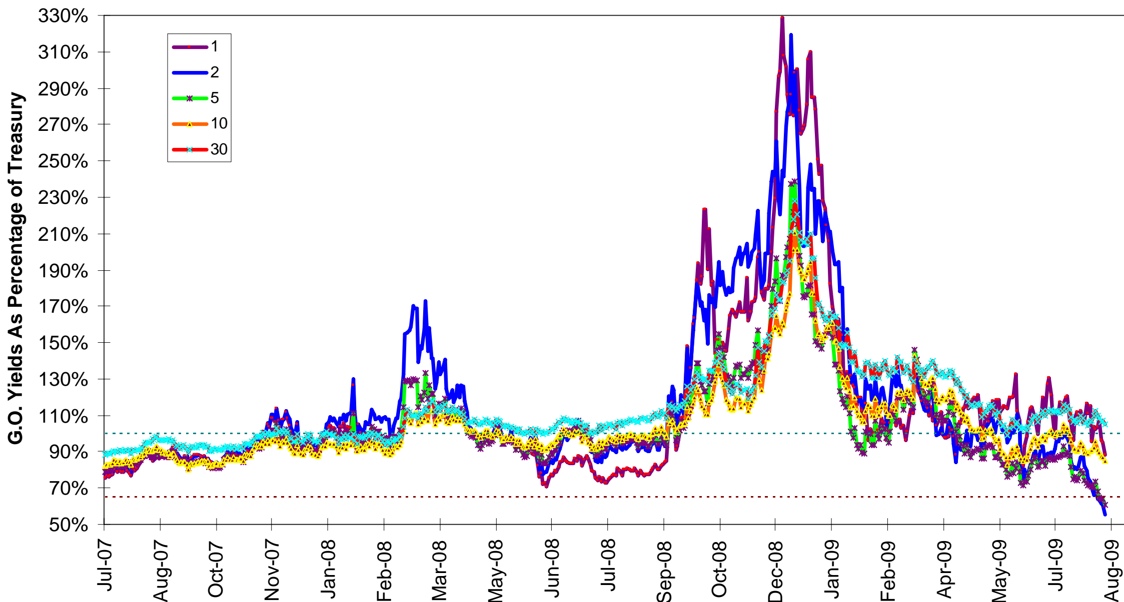
How would billions of dollars of free money and a handful of free put options affect your trading? Thought so. This is not all that different from the situation facing state and local governments across the land. While the federal government is free to run deficits, and in sizes once thought inconceivable, and while the Federal Reserve has resorted to a form of counterfeiting called "quantitative easing" to monetize the Treasury's debt, state and local governments generally face strict restrictions on their deficits and none have the kind of printing press often seen whirling away in Washington, D.C., despite the state of California's attempts to pay in IOUs.

All Politics Was Local

This is much more than an academic consideration. In our federal system, the national government can impose various mandates on state and local governments, with the latter having to come up with ways to finance Washington's excellent adventures. Compounding this recipe for disaster is the simple reality state and local revenues, often based on income-sensitive sales taxes and real estate bubble-sensitive property taxes, tend to fall at the very time when recession-related expenditures such as unemployment compensation, rise. This lowers the credit quality of state and local governments and raises their funding costs at the very time when they can afford it least.

As a result, even AAA-rated municipal general obligation bonds, those backed not by the revenue from a specific project such as a toll road or bridge but rather by the state's taxing authority, exploded higher during the credit crunch of 2008. In a perfect world, municipal bonds' tax-equivalent yield (TEY) should be 65% of the Treasury's yield at any given maturity to reflect their federal tax-free status. They have yielded far more than this 65% level between the time the financial crisis began in earnest in July 2007 and August 2009. Indeed, they yielded far more than 100% of the comparable Treasury yield for much of this period. Both the 65% and 100% lines are marked on the chart below.

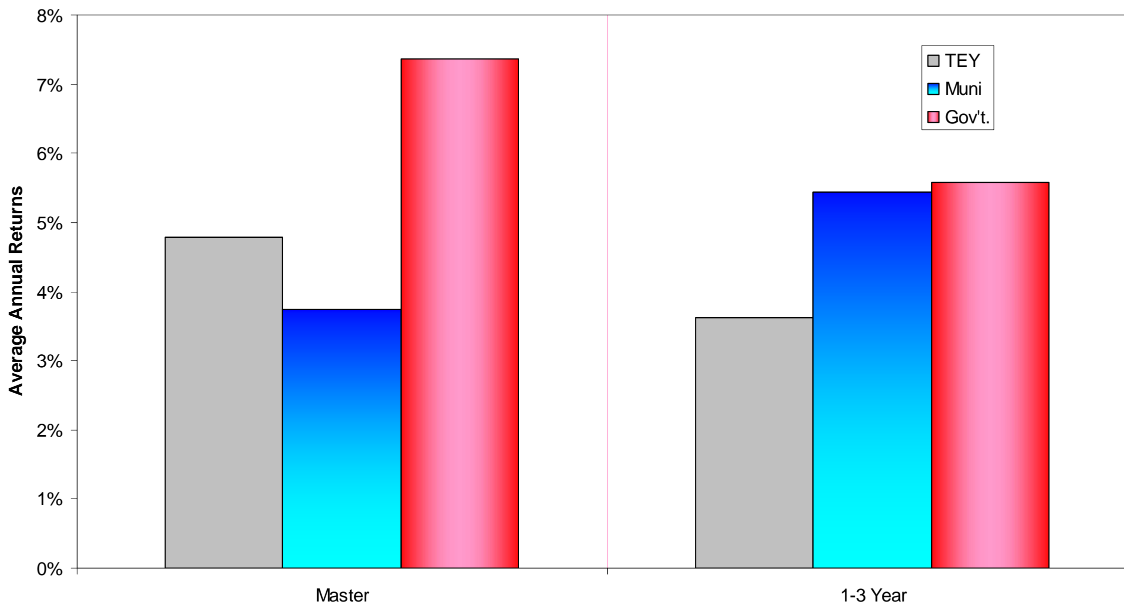
Relative Muncipal Bond Pre- And Post-Financial Crisis



Relative Performance

Another interesting point about the relationship above is how the TEY curves inverted in the fall of 2008. Many short-term municipal securities depended on weekly auctions to reset their rates on a rolling basis. When those markets ceased functioning, municipalities found themselves paying rates best understood by loan sharks.

The effect of this curve inversion on relative returns was considerable. If we compare the total returns for the Merrill Lynch Municipal Master and Government Master (agencies as well as Treasuries) indices since July 2007, we find the government bonds outperformed the municipals, which in turn underperformed their TEY level. If we restrict the comparison to 1-3 year bonds, we see the municipals returned almost as much as the governments and well outperformed their TEY level.



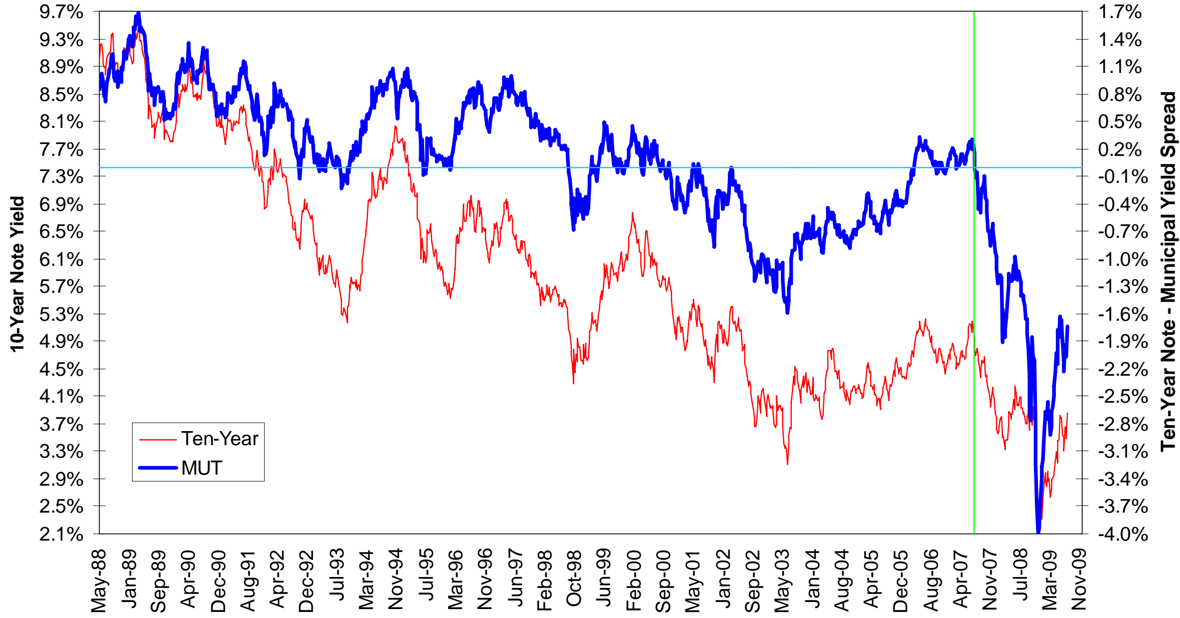
A Real MUT

We can attribute much of the strong performance by government bonds to the flight-to-quality response in the credit markets; a similar "insurance" response prevailed even in the market for TIPS (see "TIPS, Treasuries and Insurance," May 2008). In reality, this so-called flight-to-quality occurred during a time when the sovereign credit risk of U.S. Treasuries was rising (see "Sovereign Credit Risk and Currencies," *Currency Trader*, March 2009). A better name might be "flight-to-the-printing-press."

The yield spread between ten-year Treasuries and the Bond Buyer municipal bond index, the so-called MUT spread (municipal under Treasury), had been trending lower between 1988 and 2003; it reversed higher during the credit bubble and then collapsed completely once the financial crisis, marked with a green vertical line, began. The MUT spread bottomed, as did so many other bond spreads, in December 2008.

As an aside, market veterans might remember when the Chicago Board of Trade listed a futures contract on the Bond Buyer index; the contract was nearly impossible to arbitrage against the relatively illiquid cash bonds and failed. But it did support an active futures spread between itself and the long Treasury bonds called the MOB (municipal over bond) spread. If rock-and-roll heaven has one hell of a band, futures heaven has one hell of a contract graveyard.

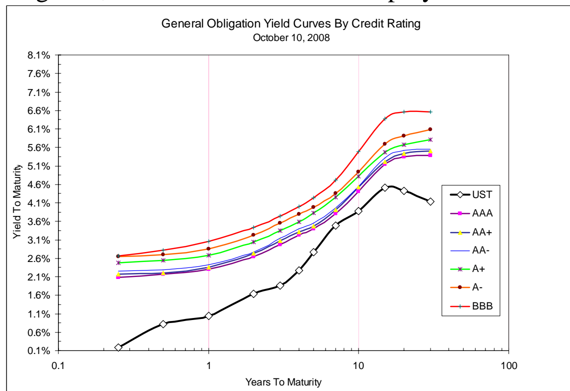
The MUT Broke During Financial Crisis

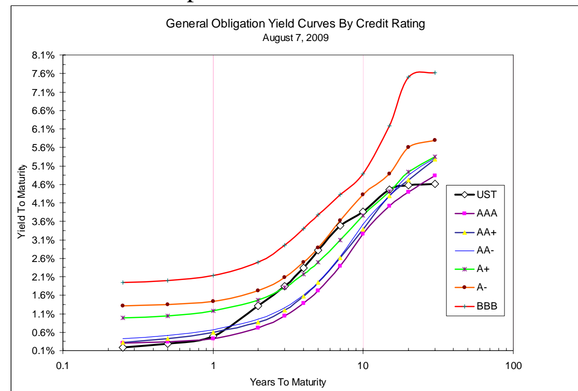


The Great Muni Revival of 2009

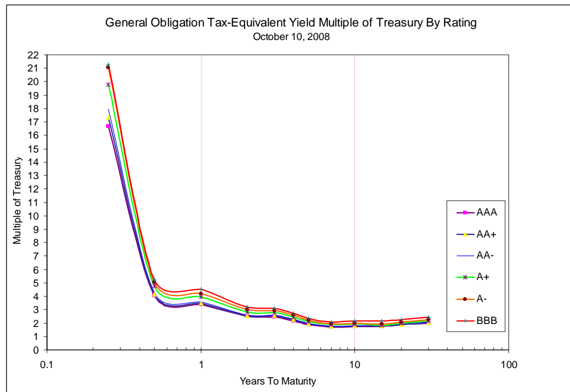
The question must arise what caused TEY levels to collapse from their highs of October 2008 back to levels prevailing beforehand? The answer is simple: It was not the dissipation of the crisis; many other markets such as stocks and high-yield credit spreads moved on to new highs in stress after October. The answer was the federal government's response, in particular the $787 billion American Recovery and Reinvestment Act of 2009 (if the spirit of George Orwell is not involved in naming these bills, it should be), the infamous package of pork passed pursuant to presidential promises. Approximately $180 billion of this sum was dedicated directly to payments to states for the various federal mandates larded up elsewhere. Of course, this bill would provide funding for two years, while the mandates would last much longer, which is why several governors, including both the now-disgraced Gov. Sanford of South Carolina and the now-resigned Gov. Palin of Alaska, threatened to turn the money down (they have not, at last counting. Hot air is a bipartisan resource).

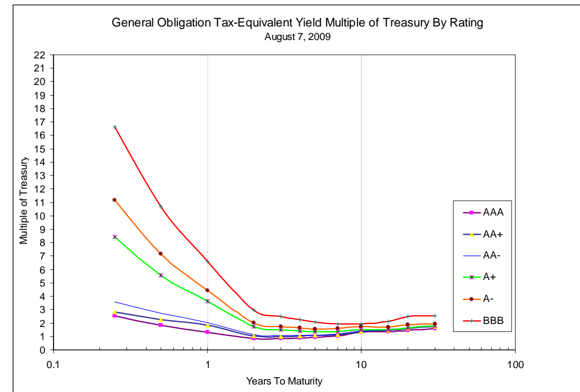
The effect of all this money, as hinted in the opening question, was to give municipal finances a free get-out-jail card. And as one former politician might have said, the impact of that money must not be mis-underestimated. Let's take a snapshot of municipal yield curve by credit rating before and after the event. A range of credit ratings from AAA down to BBB along with the Treasury yield curve will be compared between October 10, 2008 and August 7, 2009. Both dates will employ the same vertical scale for ease of comparison.





With the exception of the BBB-rated curve, all of the municipal yield curves by grade fell in level, and all steepened in shape. This suggests a renormalization of the market and a convergence back to more reasonable TEY levels. In fact, if we convert the data above into TEY as a multiple of Treasury yield, the changes become even more striking and more credit-dependent in their level and shape.





The Next Cycle

We are left with the question as to what will happen when the stimulus package expires. We can see the conundrum faced by state and local governments in every economic downturn as they get caught in a cost-revenue squeeze, and we can see as well how they were saved only by federal cash infusions. If the economic malaise resumes sometime in 2010, a statement and not a forecast, a good trading choice will be to sell municipals and buy Treasuries. Maybe the Constitution favored the states in its Reserve Clause, but that does not mean you have to do so when the federal money disappears and the states are left with the obligation to finance someone else's bright ideas.