An Unruly MOB

He's almost dead from breathing in air pollution
He tried to vote but to him there's no solution
Living just enough, just enough for the city

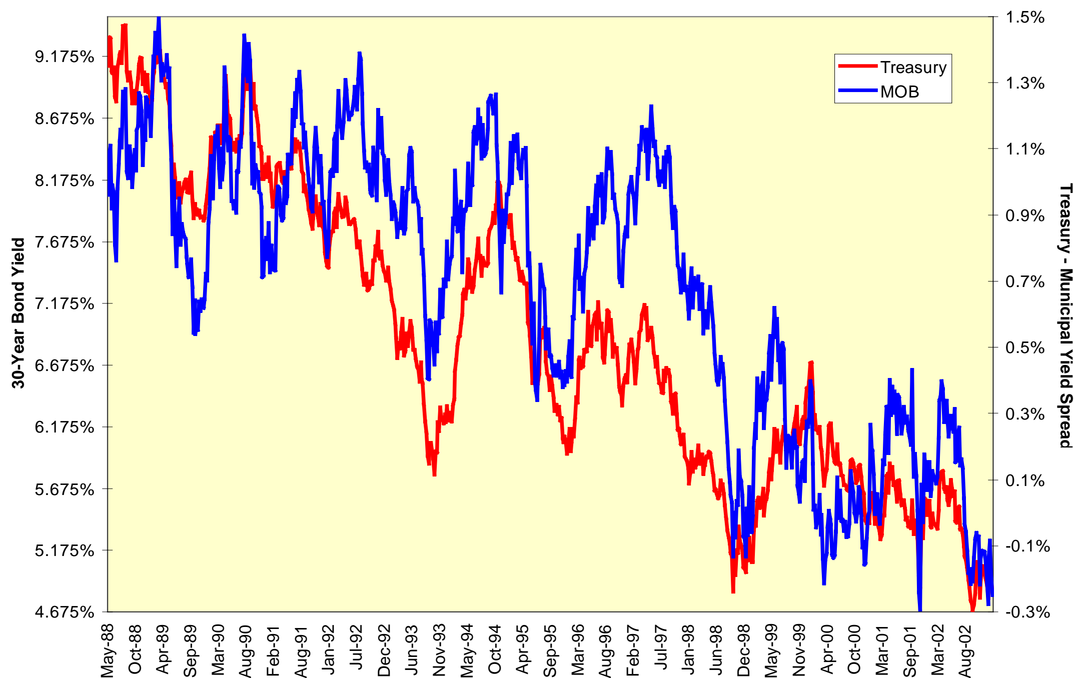
-- Stevie Wonder, "Living For The City"

It is easy to get people to pay attention to the federal deficit even though none of us really has a clear conception of what $200 billion really is. Try this: If you spent $250,000 a day every single day since the year 1 AD, you would have spent less than $185 billion.

State and local finances are in many ways worse than federal finances. Our friends in garden spots such as Sacramento, Albany and Springfield fell into their usual trap of spending excessively during the 1990s boom. Now they are facing a quadruple whammy of increased demand for services, lower tax revenues, reduced federal assistance and the threat of tax-free dividends competing with municipal bonds. And, unlike our solons in Washington, the state and local debtors do not have a printing press at their disposal.

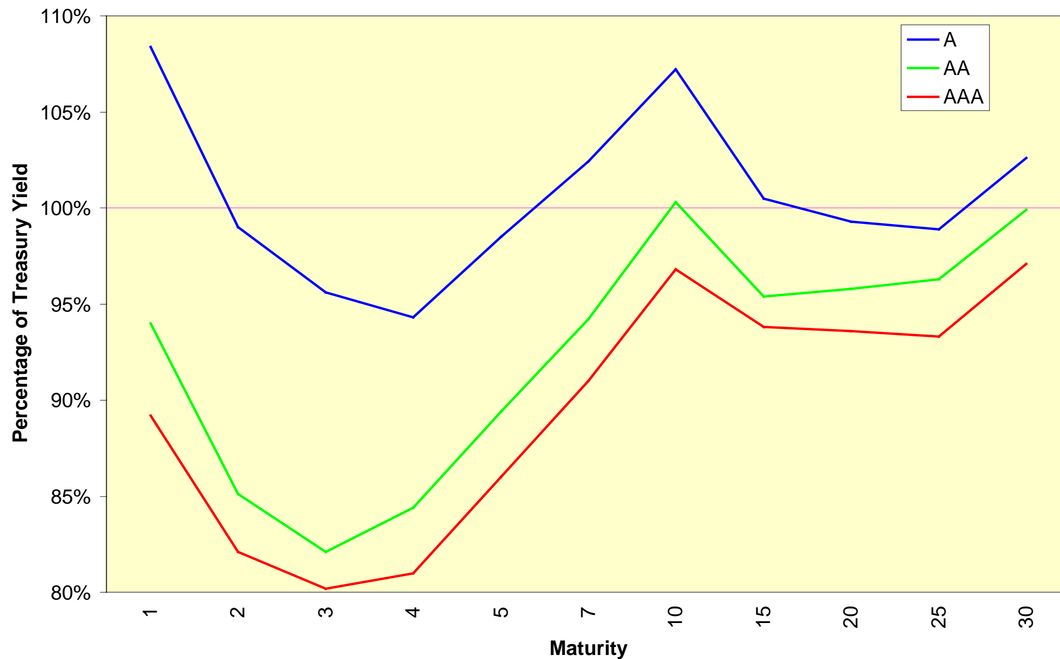
Municipal bonds, once considered second only to Treasuries in safety, have been falling on increasingly hard times for more than a generation. The near-bankruptcy of New York City in 1975 (where have you gone, Felix Rohatyn? A city turns its lonely eyes to you) alerted investors to the fact that municipalities, like Third World debtors, are difficult to foreclose. The problems got worse with the 1986 tax law; banks could no longer deduct the interest rate expenses involved in financing their municipal bond portfolios against their taxes. Finally, the interest earned on municipal bonds issued to finance private projects such as sports stadiums counts against the dreaded alternative minimum tax.

Skinny MOBsters
The yield spread between Treasury bonds, represented below by the long bond, and the Bond Buyer's index of 40 municipals narrowed precipitously in the late 1990s. The combination of a bull market in Treasuries created by fiscal discipline and low inflation and the periodic Treasury flight-to-quality rallies kept pushing this MOB (municipal over bond) spread lower and lower.



These narrow or negative MOB spreads would have been regarded as a crime against nature not too long ago. Munis generally are exempt from federal taxation, so their tax-equivalent yield should be their yield divided by (1 - marginal tax rate) adjusted for credit quality. This would place their yield at (1 - .386, or 61.4%) of the Treasury yield before adjustments are made for credit risk. Munis issued by high-tax states such as New York should yield even less as they are doubly tax-exempt.

However, the yields paid on general obligation bonds, those backed by the tax authority of the issuer and not linked to the revenue of a specific project, are much higher. Even AA-rated GO bonds are yielding more than the Treasury note at the ten-year horizon, which suggests that a great deal of risk, as much as the marginal tax rate, is being priced into the muni market at present.



Muni Risks

Several reasons in addition to those above can push the MOB toward zero-to-negative levels? First, the large number of private activity revenue bonds subject to AMT treatment makes determination of a marginal tax rate difficult to determine, but it may place the real marginal tax rate well over the statutory rate. Nothing in the administration's tax proposal addresses the AMT, which is at least as unfair as the double taxation of dividends.

Second and similar, the phase-out of Schedule A exemptions raises the effective marginal rate as well. I was on a local Web broadcast to discuss tax policy, and when the inevitable "doesn't it favor the rich?" question arose, I snapped, "I hope so!" These phase-outs are a slap in the face to all those facing them and are nothing more than a back-door way of hiding real tax rates.

Third, the IRS can challenge all municipal issues' tax status at any time, and this requires greater yield protection. Few organizations embody Machiavelli's maxim that it is better to be feared than loved more than the IRS.

Fourth, many municipal issues are callable, whereas Treasuries are not; this lowers the bonds' yield-to-worst and injects an element of negative convexity (lower total return in a falling yield environment) into the calculations. The sharp drop in yields over the past two years has led to many issues being called away from investors, who then had to reinvest the proceeds at lower yields.

Fifth, Treasuries have a permanent liquidity advantage to munis, and this advantage becomes especially pronounced during bond bear markets like 1994 and 1999. As an aside, the next bear market in bonds, whenever it comes, is going to be a doozy: Who is going to rush to lock in these yields once the market turns?

Finally, the likelihood that the double taxation of dividends will either end or be reduced makes dividend-paying stocks a formidable alternative to munis. Not only are the yields on many stocks comparable, but the dividend can grow, and the stock can appreciate. Moreover, nearly all stocks are more liquid than nearly any muni.

Put it all together, and the negative MOB does not seem so improbable. All of this begs the question, of course, of whether it is time to step up to the plate and buy munis against Treasuries. The answer is not yet. Once this trade begins, and it will with a stronger economy, it will last for several years. There is no reason to be the first kid on your block, in whatever municipality that block is located, to buy.