

Getting Involved With The MOB

If you can't beat 'em, join 'em. Anyone who was watching the recent budget debates in Washington had to come away shaking their head with the sad realization those guys don't have to play by the same rules as the rest of us. Whether the economy rises or falls, the government's take – state and local as well as federal – just keeps on rising. Maybe George Orwell missed a little on his apocalyptic vision of *1984*, unless you want to count credit rating agencies data-mining your purchase patterns as Big Brother, but he sure got it right in *Animal Farm*: Some are more equal than others.

This column's unceasing advocacy of self-reliance in economic life – if you really think an industry's gouging you, buy their stock rather than waste your breath complaining – extends to Uncle Sam and his fifty nephews as well. In the absence of widow-and-orphan stocks (oh yeah, name one!) and with the ever-decreasing maturity of corporate bonds, municipal bonds may represent one of the last great reservoirs of pricing power in the modern economy. State and local governments are shielded from the forces of competition and can raise their prices (taxes) at rates far greater than their productivity, such as it is, can expand.

The big advantage for municipal bond investors is, of course, exemption from federal taxation on qualified issues; the bonds normally are exempt from taxation in their home state as well. Of course, since we are dealing with taxation issues, life is never simple, and there are issues involving amortization and accrual of bonds purchased at premiums and discounts, respectively. In addition, municipal bonds issued to finance private projects may be subject to the dreaded Alternative Minimum Tax.

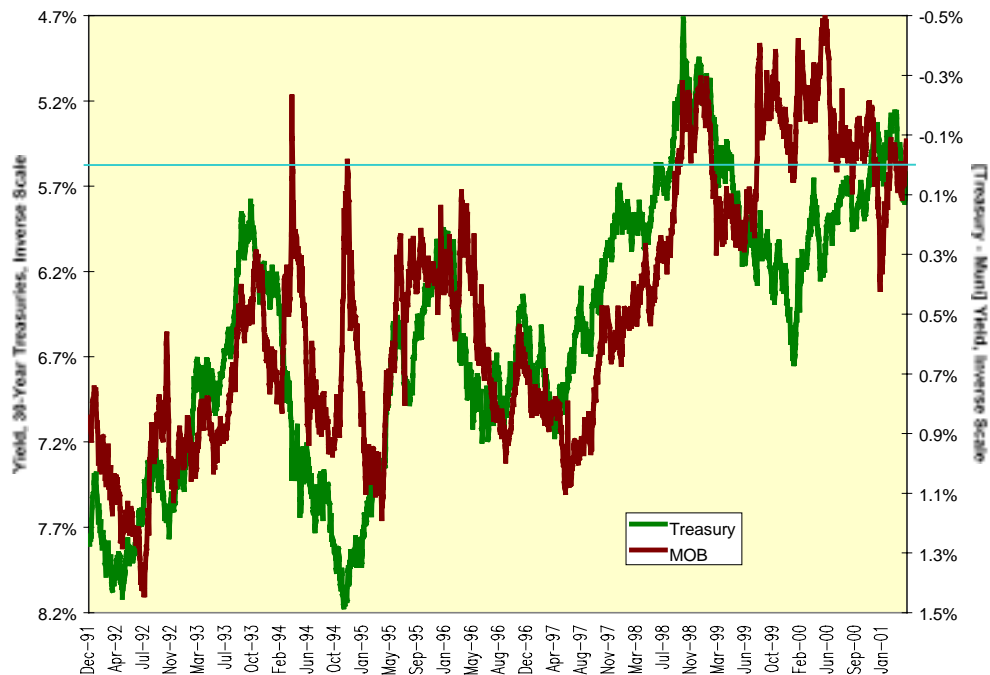
Given all of this, are there are investment opportunities in buying municipals, especially in a spread against Treasuries? The so-called MOB (municipal-over-bond) spread can be executed easily and effectively via the Chicago Board of Trade's futures contracts on Treasuries and on the Bond Buyer's 40-member municipal bond index.

MOB History

The MOB spread normally is quoted as the difference in price between the muni bond and T-bond futures, but the history below will be presented as yield to sidestep the conversion of both contracts to a 6% basis starting with the March 2000 expiration. The yield scales are inverted to parallel price movements. The gradual "uptrend" in the MOB line in the chart below corresponds to a decade of secular outperformance of munis by Treasuries.

Treasuries typically yield more than munis; the equivalent taxable yield of a municipal bond is its yield divided by $(1 - [\text{marginal tax rate}])$. At times, however, the MOB can go negative; this happened during the 1994 bear market in bonds and just prior to the onset of the 1999 bear market in bonds. The ongoing Treasury buyback of long-term bonds has kept the MOB negative nearly continuously from August 1999 onwards. A notable aberration occurred in January 2001, as the market briefly pushed the MOB toward 70 basis points in anticipation of Bush tax cuts. This rally was negated quickly, and the MOB is once again negative.

MOB Influence Over The Treasury



A Kinder, Gentler MOB?

Other than the Treasury buyback, are there any reasons for the MOB to ever hover at zero-to-negative levels? Yes, and nearly all are related to tax policy. 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. Second and similar, the phase-out of Schedule A exemptions raises the effective marginal rate as well. Third, the IRS can challenge all municipal issues' tax status at any time, and this requires greater yield protection.

In addition, many municipal issues are callable, whereas Treasuries are not; this lowers the bonds' yield-to-worst and injects an element of negative convexity into the calculations. And, as the recent downgrade of California bonds as a result of the electricity debacle should remind us, the credit risk of munis is considerably greater than that of Treasuries. Finally, Treasuries have a permanent liquidity advantage to munis, and this advantage becomes especially pronounced during bond bear markets like 1994. Put it all together, and the convergence of Bond Buyer Index and Treasury yields doesn't seem so out of line.

If the Fed's ongoing loosening continues through its May 15 meeting, which appears increasingly likely given the weak employment report of May 4, the yield curve will continue to steepen and stocks will continue to outperform bonds. Eventually, as noted in this space last week, (see "Waiter! There's A Bear In My Bonds!" May 2, 2001) a vicious bond bear market could emerge. This will make the trade of selling munis and buying Treasuries even more attractive. You could do this trade with the CBOT futures while keeping your tax-advantaged muni bonds and muni bond funds. Some trades are more equal than others.