Singing Election Year Muni Tunes

Sitting on a sofa on a Sunday afternoon
Going to the candidates' debate
Laugh about it, shout about it
When you've got to choose
Every way you look at it, you lose

…"Mrs. Robinson," Simon and Garfunkel

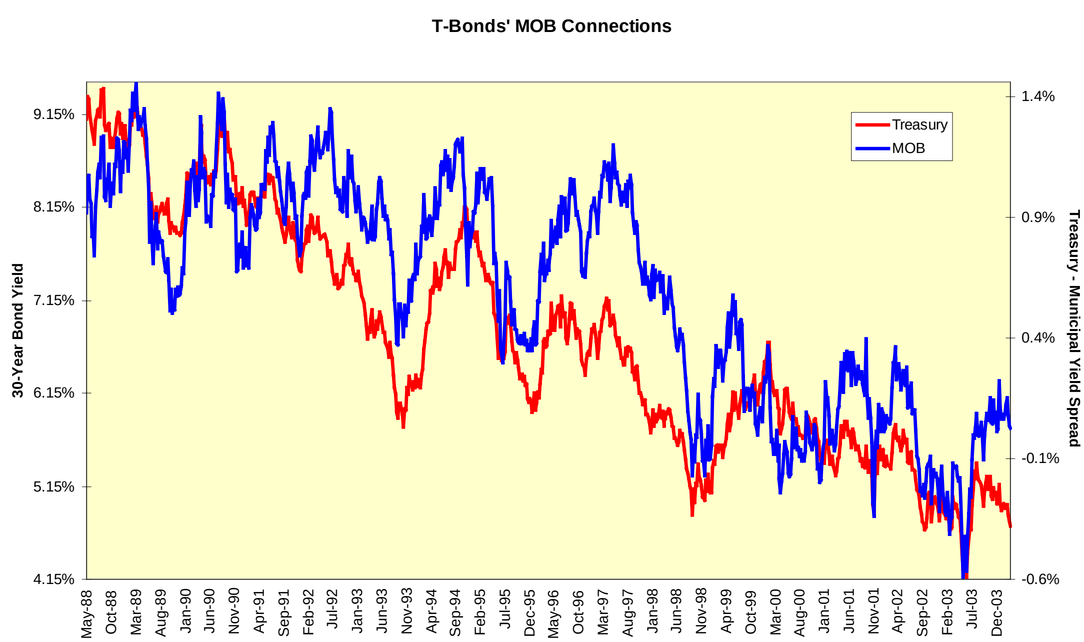
The municipal bond market had a lot of sand kicked in its face in recent years, including lower marginal tax rates, lower taxes on dividends and capital gains, the skirting of junk status by California, an end to the easy money states reaped during the 1990s bubble and a tepid economy.

It was not unalloyed bad news, though. Municipalities, like all borrowers, benefited from the general decline in interest rates over the past few years. Viewed in another light, water reclamation districts and toll road authorities have been the indirect and surely unintended beneficiaries of Japan's recent currency interventions.

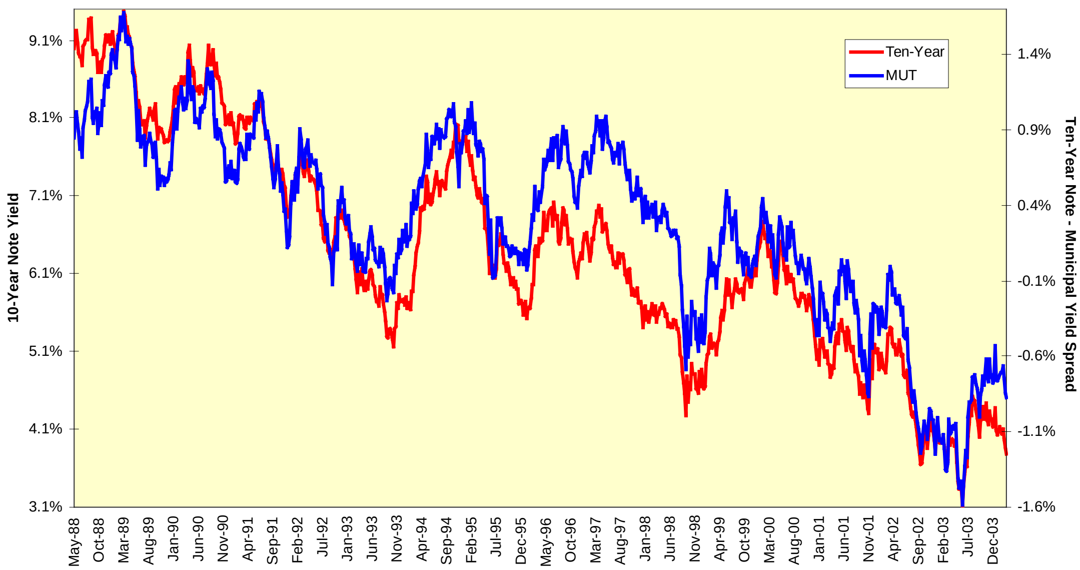
The news may turn far more decidedly in favor of this sector of the bond market. First, I will go out on a limb here and forecast that regardless of who wins the White House in November effective marginal tax rates will rise. Second, just as municipal borrowers benefited from the general decline in interest rates, they will get a free ride higher on local property taxes. One of the cruelties of home ownership is that your replacement cost, the next piece of property you may wish to purchase, is rising in price at a more or less equal rate to your current abode. Realtors and tax collectors can capture these gains, the capitalization of lower interest rates, far more effectively than can the homeowner.

MOB And MUT Spreads

Let's revisit the history of the municipal-over-bond, or MOB spread, which I wrote about last in January 2003, and add the municipal-under-Ten year, or MUT spread for a more complete picture. The *Bond Buyer*'s index of 40 municipals provides the proxy for municipal yields.



No Ifs, Ands Or MUTs

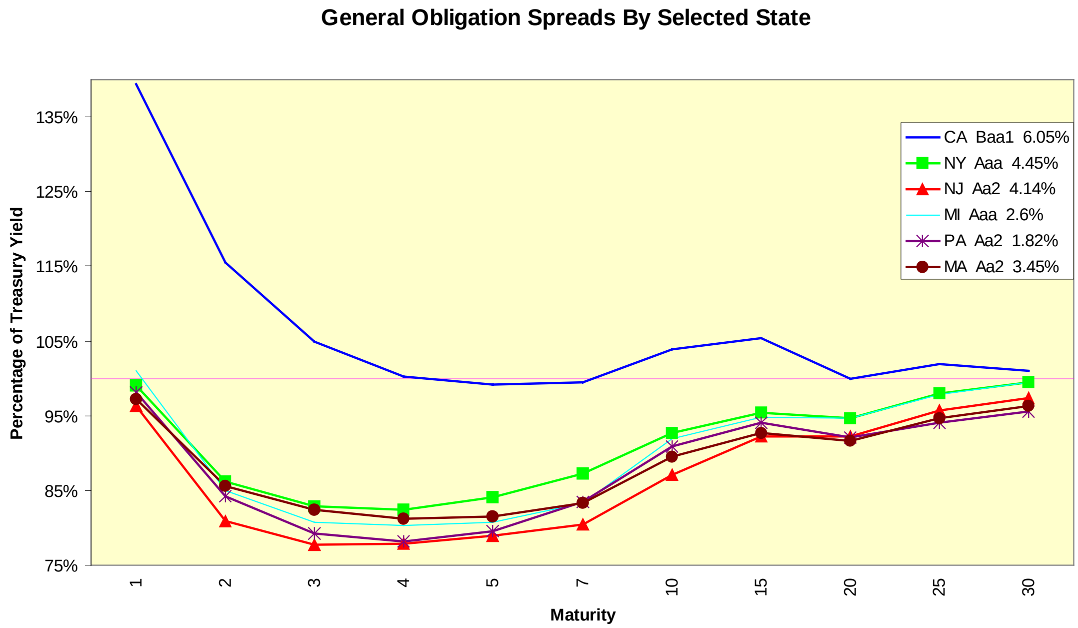


If I were to take the labels off these charts, especially for the MUT, a casual observer would have every reason to believe they depicted two very closely related economic time series, such as two substitutable grades of crude oil. As bond yields have declined steadily over the past fifteen years, both the MOB and the MUT went negative for periods of time for reasons stated in the earlier article. The current phase of the bond rally, which very well may continue, will serve to narrow the MOB and MUT spreads even more. If fixed income investors are going to get stuck with lower yields, they might as well get some tax benefits as part of the package.

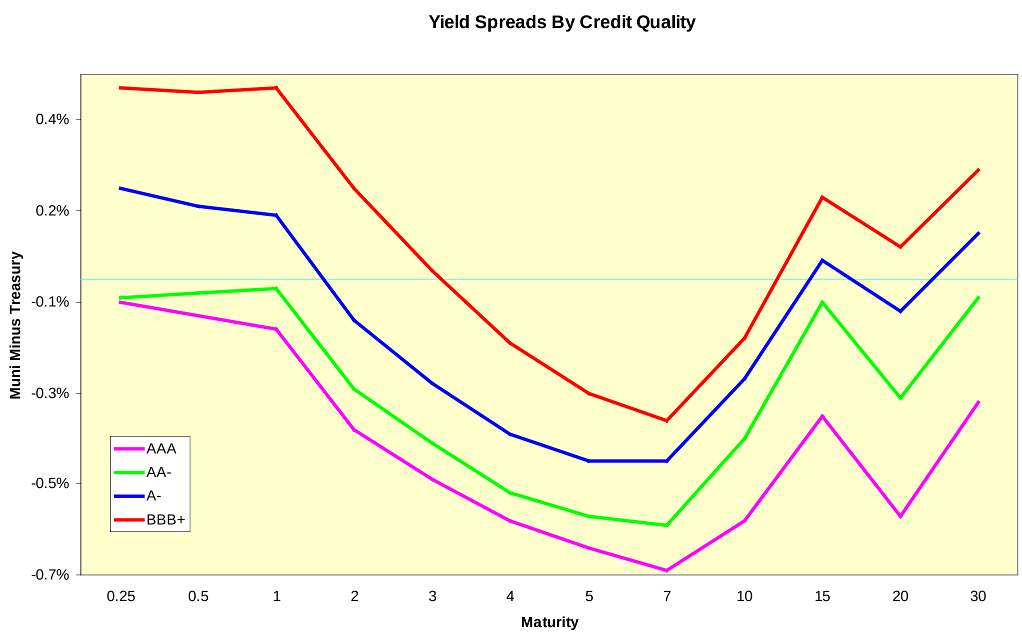
A Market Of Bonds

Active stock managers are forever emphasizing the need for “selectivity,” as opposed to just going out there and filling your pockets with whatever index strikes your fancy at the moment. The simple fact here – and this is not to weigh in on the perpetual active vs. passive management debate – is you can buy the market via an index instrument in stocks, but do not even think about it in municipal bonds. Each issue is unique and nearly all are very illiquid. Even getting good price estimates, such as those published by *Bond Buyer*, is at best an art.

Each one of us lives in a local taxing authority, and since most states exempt their own bonds from their own taxes, these tax rates must be accounted for in the effective after-tax yield. In addition, each state has its own credit rating, and that most certainly affects the yield on the bonds if for no other reason than we are unlikely to dispatch either the Marines or an IMF bailout team to, say, Sacramento. The chart below depicts the yield to maturity of selected states’ general obligation bonds as a percentage of comparable maturity Treasury yields. The states’ Moody’s credit rating and individual tax rates are included in the legend.



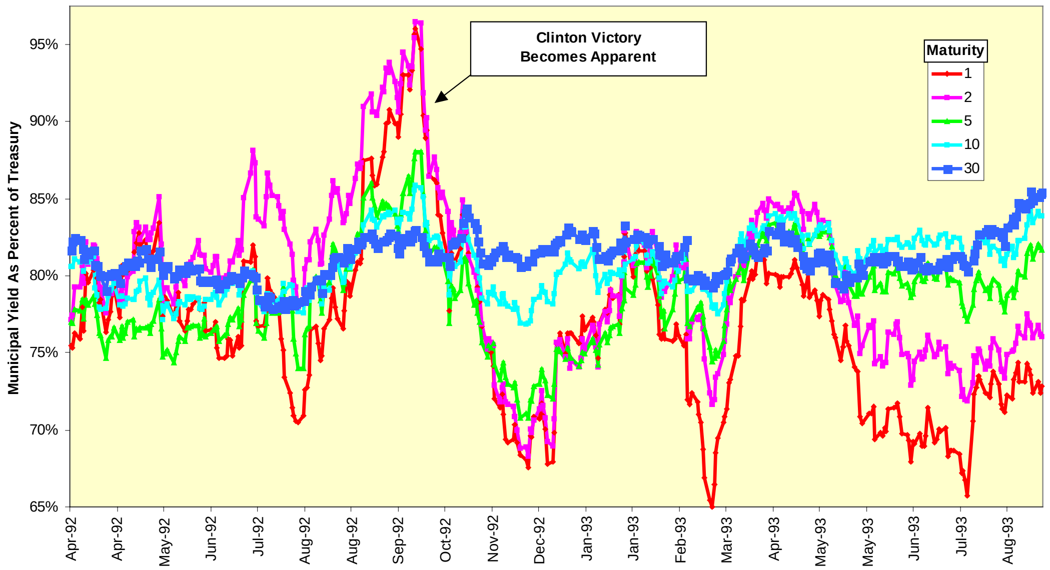
On a national aggregate basis, the yield spreads by credit quality reflect an interesting maturity dependency. At money market maturities, municipal yields are either higher than, in the case of BBB+ and A- paper, or nearly the same as, in the case of AA- and AAA paper, than comparable Treasury yields. By the seven-year maturity, the yield spreads widen out to what you should expect on an after-tax equivalency, and then they begin narrowing once again at the longer maturities for reasons discussed in the January 2003 column.



Tax And Tax, Spend And Spend…

At this stage of the 2004 election, my political forecast is no better than a coin toss, except to say my beloved Libertarians probably have no need to start measuring the White House draperies. If we turn the clock back to 1992, the last time an incumbent Republican was threatened with eviction, we can see how the expected tax thermometer of municipal yield spreads was maturity-dependent. Oddly enough, it was the short-dated notes, those with one- and two-year maturities, which fluctuated in yield relative to Treasuries than the long-dated notes and bonds. Once the Clinton victory became apparent, yields fell sharply on a relative basis for these instruments in correct anticipation of higher taxes.

Muni Yields Over 1992 Election And Aftermath



Buy Municipals And Hedge

All of the factors noted above, the potential for lower yields, a narrower MOB/MUT and the increased probability of higher tax rates, suggest a strategy of being long municipals relative to Treasuries, with the trade concentrated in short-dated, investment-grade municipals. A closed-end fund, which does not need to buy and sell these illiquid securities in response to cash flows, is preferable to an open-end fund; there are a large number of these funds, many concentrating in the issues of high-tax states.

While the iShares Lehman 1-3 Year Bond fund (SHY) is the ideal instrument to sell against such municipal bond funds, the SHY does not have options. For those of you with futures accounts, put options on the mid-curve eurodollar future or on the two-year Treasury note make for the ideal hedge instrument.