Who Fled The Muni Market?

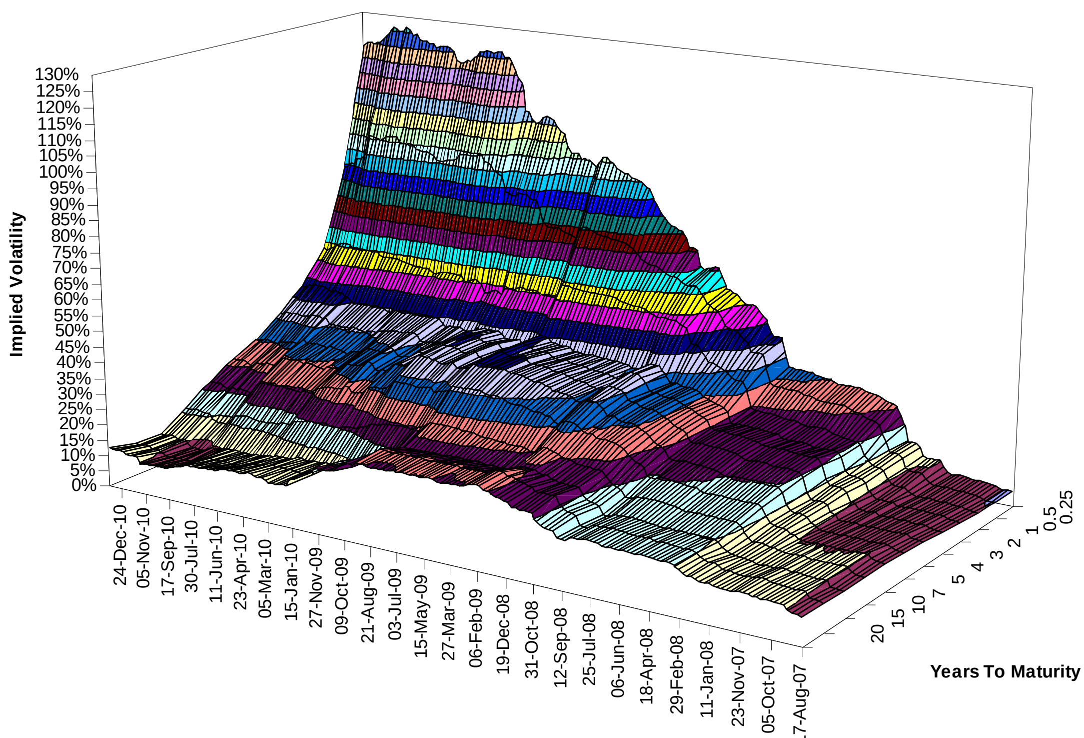
Financial life is full of paradoxes. Veterans of the 1980s savings and loans fiasco might recall the "Texas run" wherein brokered CDs were sent to the shoddiest institutions in amounts qualifying for federal deposit insurance because these S&L's paid higher rates. Both bubble reflations of the past decade, the ones commencing in 2003 and in 2009, began not with investors tip-toeing back into high-quality issues but rather diving headfirst into marginal issues, a move known as "the dash for trash."

So it is with the recent experience in the municipal bond market. You might think the first bonds to be shed would be from mangy issuers such as my home state of Illinois (Inscribed on the Illinois Memorial at Vicksburg: Not without thy wondrous story / can be told the nation's glory) and would proceed from the longest-dated issues downward to supposedly less-risky short-dated paper, but you would be wrong on both counts.

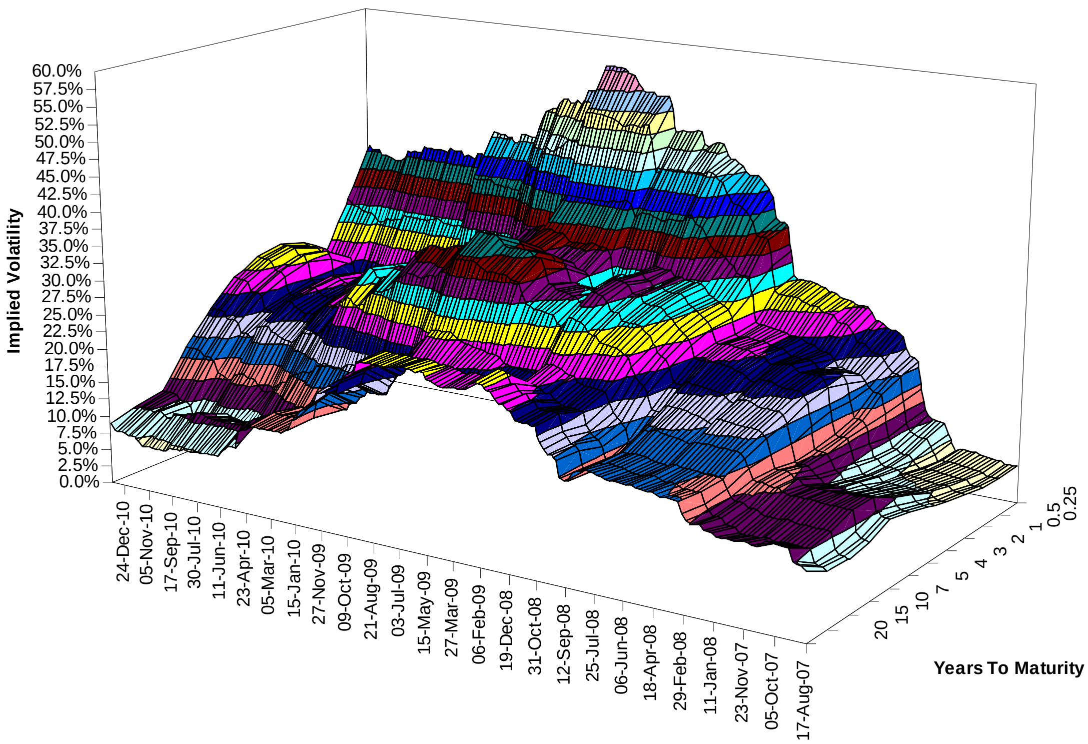
Municipal Volatility

Volatility data are available for general obligation municipal bond indices ranging in maturity from three months to thirty years and from credit ratings ranging from AAA to BBB. The paths of volatility across the dimensions of time and maturity are illustrated below for two of these indices, AA+ and A-. Every picture tells a story, and this one is simple, direct and counterintuitive.

General Obligation Municipal Bond Volatility: AA+



General Obligation Municipal Bond Volatility: A-



In the AA+ picture as well as for AAA-rated bonds, we see a large jump in short-dated volatility in mid- and late 2010; long-dated volatility levels declined. For the A- and BBB issues, short-dated volatility peaked in mid-2009 and fell in 2010.

What can explain this odd mix? Three factors in addition to the dreadful state of municipal finances came into play in 2010. First, the expectation for much of the year was the 35% top marginal tax rate would revert to 39.6%. Second, the expectation was the preferred tax treatment for dividends and capital gains might expire. Third, many held out hope for an extension of the Build American Bonds program. None of these factors came to pass after the November election; the result was an expected increase in municipal issuance to offset the BABs, the absence of a higher tax rate and continuation of preferred tax treatment for equity-derived income at a time when the Federal Reserve was goosing all risky assets. Small wonder municipal investors headed for the exit.

At the head of the line out the door were the most risk-averse coupon-clippers, those whose intentions were to buy the highest-quality bonds with the least interest rate risk. Once these bonds became less valuable and general interest rate risk began to rise, they decided not to play the game anymore.

What about those who stayed put at the long end and for lower-rated issues? They knew the risks they were taking and probably felt when push came to shove the federal government would bail out miscreants such as Illinois. Where would they ever get such an idea, that the federal government would reward the irresponsible at the expense of the prudent? The world wonders; I do not.