Dissecting Muni Credit Spreads

Attorneys reading this may smile at the following: Most clients want a more complex answer than is necessary. If a problem can be solved by a one-page contract, clients will feel uneasy and demand some real boilerplate for their money. It is really no different in market analysis, especially during the topsy-turvy and heavily manipulated markets we have been living through for what seems forever: Complexity drives out simplicity.

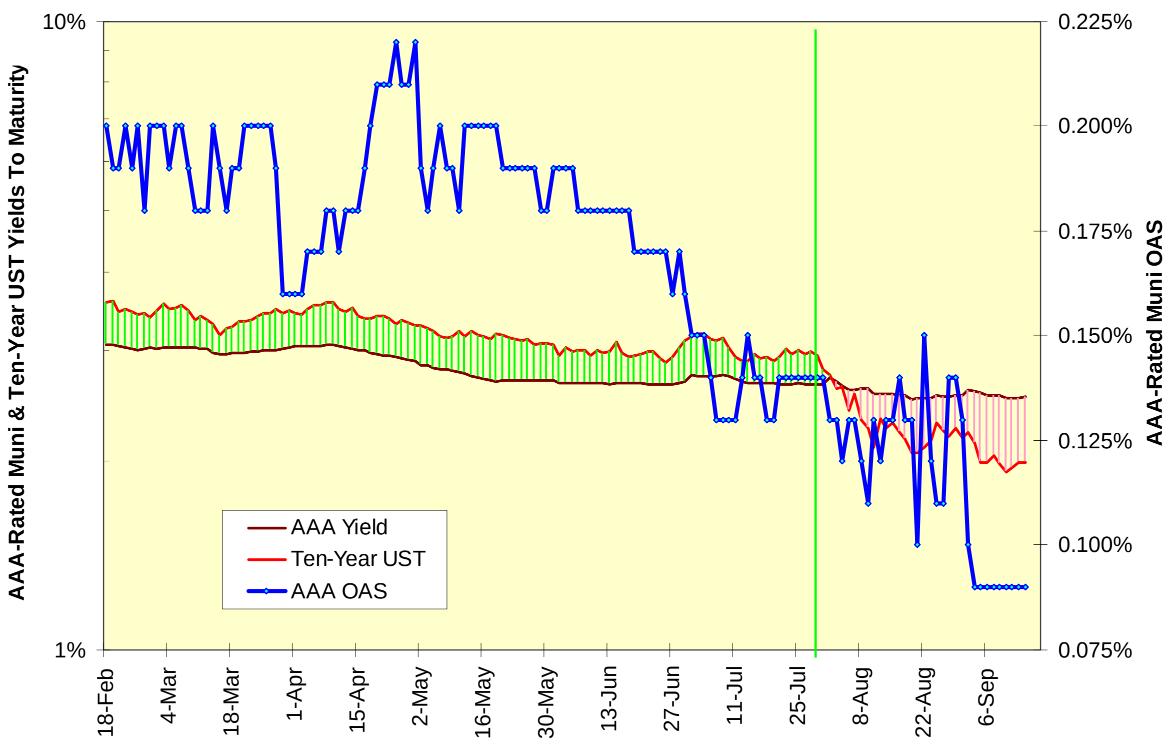
Let's take the issue of municipal credit spreads. It is no secret our state and local governments are in a bad way. Part of President Obama's otherwise lackluster $447 billion "jobs-creation" proposal, just like the 2009 American Reinvestment & Recovery Act, involves a massive federal transfer to the states. We should expect anything that threatens this lifeline, real or imagined, would be a negative for municipal bonds and would manifest itself in higher option-adjusted spread (OAS) levels.

Look To Treasury Yields

Let's analyze this in the same way we did for corporate credit spreads earlier this month. The yields and OAS levels for four different ratings of municipal bonds, AAA, AA, A and BBB were used along with matching-maturity Treasury yields. The AAA rating matches to ten-year Treasuries, the AA to fifteen-year Treasuries and both the A- and BBB-rated to twenty-year Treasuries. Only the AAA and AA charts will be shown below.

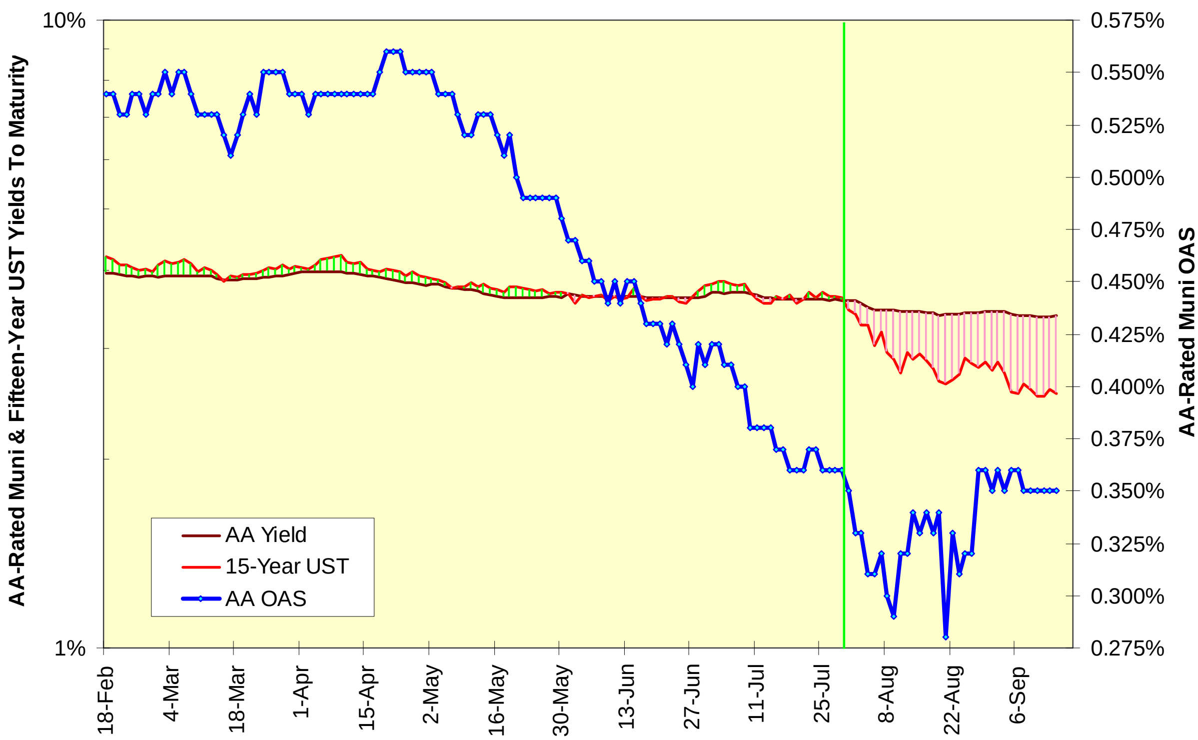
As an aside, I am increasingly uncomfortable using any of these credit ratings at all. We know the ratings firms covered themselves with something other than glory during the whole mortgage mess, and the whole Standard & Poor's downgrading of the federal government episode culminated with an unceremonious plank-walking sure to have a chilling effect on others who express opinions unwelcomed by their recipients. So saying, nine states have a AAA rating and another 28 have ratings between AA- and AA+. This is really Lake Wobegon stuff.

What we can and do see before and after July 27, 2011 is how AAA-rated yields remained flat while ten-year Treasury yields fell and fell quickly.



If we shift to the AA-rated issues, the picture is similar; here it is fifteen-year Treasuries whose yields fell quickly.

Treasury Yields Fell Faster Than AA-Rated Muni Yields Fell



If we added in the A-rated and BBB-rated issues, both of which are matched against twenty-year bonds, we would find the most important determinant of whether changes in returns from July 27, 2011 onwards is not anything related to the relatively illiquid municipal bonds but rather the very liquid Treasuries. Moreover, it is the weighted-average life (WAL) of the matching Treasury security that is the most important factor: The longer the WAL, the more likely it was returns were unchanged during the period of bond market tumult.

This is a very simple answer and is unrelated to all of the unique factors inherent in each and every municipal issue. Just look to the bond index' WAL and you will learn most of what you need to know about its realized volatility of returns.