Mid-Year Muni Market Update

June 24, 2014

The municipal bond market faced a rather tough year in 2013, with news of troubles in Detroit, Puerto Rico and elsewhere scaring off some investors. This year hasn't exactly been smooth sailing for the muni market either, but the waters seem a bit calmer and many investors have returned to the sector. Rafael Costas, Co-Director, Municipal Bond Department, Franklin Templeton Fixed Income Group®, could be called cautiously optimistic about the muni market. He provides an update on some key market developments, including progress in the aforementioned trouble spots.

All markets experience periods of volatility, including munis. Last year was one of those volatile periods, and not just for munis but for most fixed income investments. In May 2013, then-Federal Reserve Chairman Ben Bernanke started talking about the so-called "tapering" that is now taking place. At that time, the market didn't seem to be ready for that kind of an announcement and fixed income investors suffered. The fixed income markets generally stabilized relatively quickly after that shock, but Detroit added another punch to the muni market when it filed for bankruptcy in July. Then, in August – September, stories started breaking out about certain problems that Puerto Rico was experiencing with its finances. The negativity of these two stories kept feeding a market that was already reeling to a certain extent, and the industry saw net redemptions as a result. At the same time, the equity markets were experiencing a pretty good year. Investors tend to follow performance, so we saw a rotation into equities as a result. At the end of the year, there seemed to be an expectation that this trend would continue, that equity markets would keep moving up and that fixed income wasn't going to be the place to be. That prediction didn't exactly play out during the early part of 2014.

A trend we have seen continue to play out in the muni market, on the other hand, is a relative lack of supply. Supply has actually been dwindling for about four years, since the Great Recession. There is no real talk of supply increasing in 2014, and demand has been returning. So, supply and demand are both working for price recovery and stability, which is what we have seen so far this year. We see two main reasons for supply shortage. First, the 2008-2009 financial crisis was a big global shock, and it led to a lot of austerity taken by individuals as well as governments. So we saw a pullback in supply to finance the "nice-to-have" projects as opposed to "need-to-have" projects. But we think the bigger issue for the municipal bond market—an issue that continues to grow—is the extent of municipalities' obligations now due to public employees by way of pensions or post-retirement benefits. These obligations are crowding out financing for other things these governments are providing, like police services, parks and social services. To meet these obligations, one of the things some issuers have decided to do is to refrain from issuing any more debt via the traditional municipal bond market route.

Credit quality can be another drag on the muni market, but on the positive side, we've seen a slow increase in credit quality over the past year. In general, the sector has been recovering in terms of income tax collections, sales tax collections and property tax collections, the latter of which has benefitted from a housing market rebound in some areas of the country.

Slow Progress in Puerto Rico

Puerto Rico's general obligation debt was downgraded to below investment-grade earlier this year by all three major ratings agencies: Standard & Poor's, Fitch and Moody's. We are of the view that it could take Puerto Rico a number of years to regain its investment-grade rating. That said, it's been a good year for Puerto Rico debt in terms of price return. It is the best-performing sector in municipal bonds this year, and this year so far has been generally good for munis. Puerto Rico is facing a mountain of obligations, its economy is not really growing, and its government is trying to figure out how to get the economy growing again. There continues to be a lot of noise surrounding Puerto Rico, and we think it's going to be a long story that could have a few ups and down. As any good news comes out, we believe that its bonds will rally, and as bad news comes out, we believe its bonds will lose some value, maybe more than the rest of the market. We are long-term investors, and we hope that in the long term things will work out and Puerto Rico should be on a better fiscal and economic path.

A Tale of Two Cities: Stockton and Detroit

In early June, the trial to determine how Stockton, California, will exit Chapter 9 bankruptcy protection concluded, and the city defended its plan to handle liabilities to creditors (including Franklin Templeton), called the “Plan of Adjustment.” At the next hearing date on July 8, the Judge will rule on the value of our collateral and may issue rulings about the Plan. This ruling could set an important precedent about pension obligations.

When you have an item in the expense column—like pension obligations—that continues to grow in the double digits while the economy is either not growing at all or growing very slowly, that’s a big problem. That is the issue many cities and counties are facing across the United States; pension obligations and benefits are now coming due as their baby-boom generation employees begin to retire.

We decided that for now we are no longer going to be buying what we call “lease revenue debt” in California for our portfolios, or as it is also known, Certificates of Participation in California (COPs). That’s significant as it has been the preferred tool for financing for a lot of localities. The pension funds in California, as well as in Michigan where the bankruptcy case is going on in Detroit, claim that they are protected by their own state constitutions from being re-negotiated. Until that gets decided by a bankruptcy judge, we are avoiding certain local government debt. But the muni market is large, and we expect to find other opportunities.

As far as Detroit is concerned, insurance companies have settled with Detroit which should ensure some recovery, and we believe that investors who bought bonds backed by these insurance policies should continue to get their payments in full and on time. That is how municipal insurance is supposed to work. A case like Detroit is showing people that there is, in fact, a use for insurance, which was questioned not that many years ago.

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