Mid-Term Bond Approvals May Help Close the Book on Muni Supply Saga

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The municipal bond market roared back this year after a disappointing 2013, as a dearth in supply and improved demand buoyed muni bond prices. Recent election results, however, indicate that states and cities may be fiscally confident enough to reopen their wallets to fund public projects, which could furnish muni-hungry investors with more ample supply of bonds. Rafael Costas, co-director, Municipal Bond Department, Franklin Templeton Fixed Income Group®, weighs in on the supply saga and provides an update and outlook on other muni matters.

Municipal bonds have performed well overall this year. The sector as a whole is up approximately 9% for the nine months ended September 30, 2014,[1] and pockets of the market have done better than that. The positive returns are partly due to a shortage of muni bonds in the marketplace. For example, new tax-exempt muni issues fell 1.8% from October 31, 2013 to October 31, 2014,[2] continuing a years-long trend.

While lower supply and higher demand have brought about this year's strong price performance, the flip side is that, as bond prices rise, yields fall. Because our main mission is to provide tax-free income, we would not be troubled by a small, gradual rise in interest rates. We would then be likely able to invest in higher-coupon bonds that would, in turn, allow us to potentially improve the income profile of our strategies.

Based on results from the November US mid-term elections, it appears that the supply tide may be turning. Voters nationwide approved bond measures that will fund projects as varied as water storage facilities in California to technology updates for schools in New York state. So, we're optimistic that more bonds may be issued, hopefully starting as early as next year.

Supply Story

The muni bond supply slump emerged in the aftermath of the 2008-2009 recession. Even when the recovery arrived, it came with slower growth than people expected, and there was a general reluctance to take on more debt. Many municipalities issued debt only to address pressing problems: for example, a water facility that didn't comply with environmental laws. They didn't issue debt for other "nice to have" types of projects that were not truly essential.

At the same time, state and local governments were staring at daunting pension obligations and retirement benefits as baby boomers started retiring and collecting those benefits. Whether it's called debt or not, a pension obligation is just that; it's an obligation that has to be met one way or the other. Funding pension obligations can crowd out regular municipal debt and expenditures intended to pay for projects such as fixing roads, social services, emergency response systems and school programs. Regardless of why states and municipalities had decided to forego issuing bonds, we believe the shortfall in spending on US infrastructure must be addressed. The American Society of Civil Engineers has estimated that about $3.6 trillion in essential projects need to be built; that's roughly the size of today's entire muni market.[3] We believe most of the money needed to pay for the new infrastructure will likely be provided by the sale of muni bonds.

While muni bond supply has dropped off, demand has picked up, and has been stronger than it was at the end of 2013. Last year, muni bonds were hit with the news of Detroit's bankruptcy, Puerto Rico's debt problems and the Federal Reserve's announcement that the end of its accommodative monetary policy was in sight. While demand had rebounded by mid-November 2014, muni bond funds haven't made up what was lost in terms of outflows in 2013. In addition, most of the renewed demand this year has come into the short and intermediate parts of the yield curve. Many investors are worried about long-term interest rates rising, and they don't want to be in the long part of the curve. It's really hard to accurately forecast demand, so we can't predict now if it will continue to strengthen. In today's world, news from anywhere can affect any market.

Feds Impose New Banking Rules

A recent move by banking regulators also may be influencing the muni market. In September, federal bank regulators ruled that large and internationally active banks will be required to maintain “high-quality liquid assets” (“HQLA”) that can easily be converted to cash to meet short-term liquidity needs. HQLA include central bank reserves, and government and corporate debt. The new liquidity coverage ratio rule will be phased in over three years beginning on January 1, 2015. For the time being, unfortunately, muni bonds are not considered HQLA, although regulators are considering a proposal that would allow highly liquid municipal securities to fall under the HQLA category.

Going forward, we believe this new ruling will likely exacerbate volatility during the selloffs our market occasionally experiences. In the past, banks could be counted on to alleviate some selling pressure by buying securities for their own inventory. They would turn around later and sell those securities at a profit. But if it’s expensive or undesirable for banks to maintain an inventory, they are not going to be there to step in as the buyer of last resort when markets decline, which could exacerbate downward pressure on prices. The result has been more volatility in the muni market. We would emphasize the importance of holding on through these volatile periods—something many investors are unwilling to do, which is unfortunate because paper losses then turn into real losses, and few ever get back in the market to participate in any subsequent market recovery.

Los Problemas de Puerto Rico: Will They Pass with Tax Reform?

The Commonwealth of Puerto Rico passed a law in June 2014 that would allow certain public corporations (although not the government as a whole) to file for reorganization if they were to become financially insolvent. Its proposed process is based along the lines of the Chapter 9 option available to municipal borrowers under the US bankruptcy code. We feel the law goes beyond Chapter 9 in how bondholders would be treated and, therefore, have filed a lawsuit in the Puerto Rican District Court challenging the constitutionality of the act. Regardless of the outcome of the litigation, our bottom line on Puerto Rico is that its ultimate return to financial health is going to come down to whether the leaders there can get the economy to grow organically, and materially, which has been a challenge over the last few years. The Puerto Rican government is planning to introduce a tax reform program that it hopes will promote such organic economic growth and also address the problem of tax evasion plaguing the current system.

We have been reducing our overall exposure in Puerto Rico across our funds over the last couple of years. As of September 30, 2014, our exposure was less than half of what it was in June 2012.

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All investments involve risks, including possible loss of principal. Municipal bonds are affected by interest rate movements. Municipal bond prices, and thus, a tax-free income fund's share price, generally move in the opposite direction of interest rates. As the prices of the municipal bonds in a fund portfolio adjust to a rise in interest rates, the fund's share price may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. Funds that hold a portion of their assets in Puerto Rico municipal bonds have been impacted by recent

adverse economic and market changes. These changes may cause fund share prices to decline. For investors subject to the alternative minimum tax, a small portion of fund dividends may be taxable. Distributions of capital gains are generally taxable.

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1. Source: Barclays Capital POINT/Global Family of Indices. © 2014. Based on the Barclays Municipal Bond Index, year-to-date as of 10/17/2014. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is no guarantee of future results.**

2. Calculations performed by Franklin Templeton Investments from data sourced by Thomson Reuters and Bond Buyer.

3. Source: American Society of Civil Engineers, "2013 Report Card for America's Infrastructure," March 2013. The report card is published every other year.

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