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White Paper

The Municipal/Taxable Crossover Trade's Growing Importance

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Overview

- Volatility in the municipal/Treasury yield ratio creates opportunity
- Potential limits on the value of tax-exemption and deterioration in municipal credit quality may also make the trade more valuable
- Recent market conditions have offered crossover opportunities for both tax-sensitive and tax-advantaged investors
- Execution of the trade requires not only analytics, but an organizational structure that facilitates activity across investment teams and effective intra-company communication

Municipal/taxable bond crossover trade

Tax rates are an important consideration in fixed income asset allocations. Many investors in high tax brackets assume they should be invested entirely in tax-free municipal bonds, while tax-exempt investors (e.g. foundations, pensions funds) ignore tax-free bonds altogether. In both cases, investors would be better served to consider a more balanced approach, focusing on the potential after-tax return and risk of all fixed income sectors.

Tax-exempt investors can benefit from "crossing-over" into tax-free municipals when municipal bond yields rise to abnormally high levels relative to taxable bonds. Conversely, taxable investors can benefit from the crossover trade in reverse: i.e., buying taxable securities when municipal bond yields are unusually low relative to taxable bonds. In each case, both the relative yields and the potential for the markets to return to a more "normal" yield relationship are important.

Yield ratio has been volatile

The short-hand (and useful) convention for monitoring the relative value of municipal bonds versus taxable bonds is the "muni/Treasury ratio." The ratio is simply the yield of AAA-rated municipals divided by the yield of similar maturity Treasuries. For many years, this ratio had relatively modest volatility; the ratio rose or fell based on supply/demand issues, seasonal patterns, tax rate changes, and occasional unanticipated events external to the market. With the onset of the financial crisis and the demise of bond insurers, the volatility of the municipal/Treasury yield ratio increased dramatically. Similarly, the relative yield of municipal bonds to corporate bonds has been shifting with greater frequency than in previous periods. As the chart[1] below indicates, there have been periods during and immediately following the financial crisis when municipals have yielded more than Treasuries. This results in a positive carry with the potential for municipals to outperform on a price return basis as the ratio normalizes. Conversely, corporate bonds at times have been "cheap" to municipals, giving taxable investors the opportunity to move some assets into corporates with the potential of higher after-tax returns. The ratios remain volatile in the current market.

It is important to note that not all segments of the yield curve are created equal when it comes to the crossover trade. For example, there have been several occasions since the financial crisis when municipals in the one- and 30-year parts of the curve have been cheap from a muni/Treasury ratio perspective, while five-year municipals were trading "rich."

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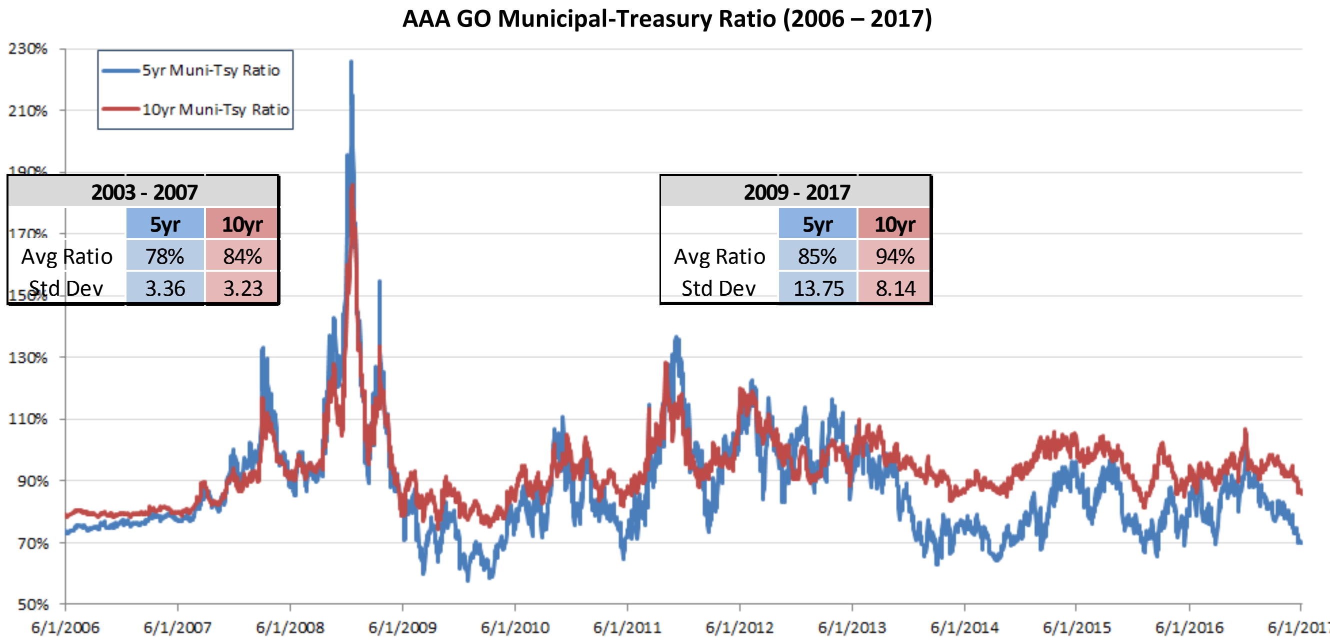

Outlook for the crossover trade

There are several factors that suggest ratios may continue to be volatile:

1. Potential continuation of the unsettled political/macroeconomic environment;
2. Proposed limitations on the value of tax exemption; and
3. Declining municipal credit quality.

While the economy has been improving, a continued path of steady growth is by no means assured. Numerous challenges remain for the domestic economy, which will only be complicated by political strife and global economic challenges. Ongoing debates surrounding the federal budget, tax reform, and healthcare reform, for example, have the potential to introduce more volatility into the markets. At the very least, the environment is ripe for headline risk.

In the wake of the most recent presidential election, much has been said about the potential for tax reform. President Trump has been very vocal about his desire to slash income and corporate tax rates, which has the potential to reduce the benefit of municipal tax-exemption. The President reportedly supports preserving the exemption after meeting with the U.S. Conference of Mayors to discuss its benefits to municipalities. However, without a detailed plan to pay for proposed tax cuts, we do not consider a cap on the exemption to be out of the realm of possibility.

Under a possible scenario, the value of tax exemptions would be "capped" at 28%. That is to say, taxpayers at higher marginal brackets will pay a tax on a portion of their municipal bond income equivalent to the difference between their tax rate and 28%. For example, a taxpayer in the 35% bracket who earns $500,000 in currently tax-exempt municipal bond interest would pay an effective tax of 7% on the interest:

$500,000 x (35% - 28%) = $35,000 tax liability

Therefore, the value of the tax exemption would fall. Although it is a surprise to many investors, there is not a high short-run correlation between tax rates and the muni/Treasury yield ratio. Nevertheless, over some period, the ratio would likely adjust to reflect this reduction in value. At the very least, the introduction of a tax on a previously tax-free asset should cause enough controversy and consternation to have some impact on market volatility.

Current market conditions do not reflect the risk of a cap on tax exemption. In fact, as of this writing, tax-exempt bonds are considered rich relative to taxable alternatives due to a supply/demand imbalance. This provides an opportunity for traditional tax-exempt investors to “crossover” into taxable bonds and benefit from expected taxable outperformance until market conditions regulate.

Less mentioned by market pundits, but perhaps more important, a longer-term decline in the credit quality of municipal bonds could cause a shift in yield ratios. Municipalities struggled in the recession, turning to a combination of service cuts and tax/fee increases to maintain adequate financial performance. Many have struggled to replenish reserves to pre-recession levels and have little room to cut expenses or taxes further, relying on economic growth to enhance their revenue base.

Looming on the horizon for many public-sector entities, however, are the consequences of significantly underfunded pension and OPEB plans. We have already seen several small, economically weak municipalities with significant underfunding problems succumb to financial distress. Even some larger states and local governments have seen rating agency downgrades in part due to their inability or unwillingness to make the necessary sacrifices to manage their growing fixed costs. There is considerable evidence to suggest that pension/OPEB problems are widespread, and many jurisdictions will have to find the means to mitigate their liabilities over the short- to medium-term. While we are not predicting widespread defaults, there may be negative consequences for municipal credit, including rating downgrades and increased price volatility relative to Treasury and corporate debt.

Each or all of these three factors–the political/macroeconomic environment, tax reform, and/or the creation of a partial tax on municipal interest income, and declining municipal credit quality–could impact the trading value of municipal bonds compared to taxable bonds. Those changing values create opportunities for the crossover trade.

Trade execution depends on organizational structure and communication

The crossover trade is no secret, but is practiced to varying degrees by institutional municipal bond investors. Property/casualty insurance companies routinely move from municipal bonds to taxable bonds, but their trade is influenced by the fluctuating profitability (and thus tax rate) of their enterprises. On the other hand, municipal bond mutual fund managers often will not participate in the trade, because their objective is to generate tax-exempt income.

Moreover, organizational rigidities may influence the ability to execute crossover trades. Firms with very substantial amounts of municipal bonds under management may be unable to find enough attractive paper in the highly fragmented municipal market to fill crossover positions for their non-municipal bond accounts. Additionally, firms with product-based profit centers may find that managers are less willing to focus on work for clients outside of their profit center. Finally, communication across investment teams is critical, since the crossover trade is not routine and requires execution by analysts and traders often functioning in disparate segments of their firms.

LIM’s Outlook

We believe that crossover trades will be an attractive source of incremental returns going forward. At LIM, we have a seasoned team operating in a small firm environment and believe we are well positioned to effectively implement crossover strategies.

[1] Chart 1, page 1 Source: Thomson Reuters; The Municipal Market Monitor (TM3)

Disclosure

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