

## Municipal Bonds: Opportunities in a Turbulent Market?

Yields on municipal bonds jumped to their highest levels in history relative to comparable Treasury yields (see chart below) as a wave of selling struck the market for the debt of cities and other tax-exempt issuers last week. The average yield on a 30-year AAA-rated municipal bond traded at 5.10% on Monday compared to a yield of 4.43% for the 30-year Treasury bond. Due to their tax-exempt status, yields on municipal bonds usually trade *below* Treasury yields. Not so this week.

### What's Going On with Municipal Bonds?

To understand why, let's review two key developments. First, over the last few months, subprime credit concerns hit the municipal bond insurers, causing investors to shun municipal-related debt, including variable rate demand note (VDRNs) and auction-rate securities (ARS). This left the banks and securities dealers with bloated inventories of unsold bonds.

#### Muni Bond "Carry Trade"

Second, to make matters worse, the municipal bond market has its own version of the carry trade: tender option bond (TOB) programs. A significant source of demand for municipal bonds in recent years, TOB programs borrow short-term funds in the variable rate demand note (VRDN) market and purchase long-term municipal bonds, capturing a profit based on the difference in yield. But, as investors balked on VRDNs, reset rates on the short-term instruments spiked to 5 to 10%. The TOBs' borrowing costs then *exceeded the income earned on the long-term bonds*. Furthermore, the long bond is typically hedged against price movements, but in recent weeks normal trading relationships have broken down and the hedge is actually adding to the strategy's losses.

With large amounts of unsold VRDNs and auction-rate bonds in dealer inventories, Wall Street is unwilling to extend funding to TOBs. Dealers are facing substantial losses of their own and are unable to support the VRDN programs. This left one option for TOB programs: mass liquidation of assets at discount prices. A huge number of these TOB programs began to unwind by selling the long-term bonds shuttering operations completely last week.

#### Potential Opportunities

On a positive note, the forced unwind by leveraged funds means high-quality, tax-exempt bonds must find their way back to real money investors. Various other non-muni investors, including hedge funds and individual investors, have stepped in to begin stabilizing the market. The municipal bond market does continue to face supply issues and concerns over bond insurers, but their tax-exempt status and low default-risk provide compelling reasons to consider municipal bond purchases at historically cheap levels.

### Background

March 4, 2008

Months of turmoil in the municipal bond market culminated this week with a massive sell-off by leveraged investors (mainly hedge funds). Despite gloomy media headlines on municipal bonds, the forced selling of good assets at distressed levels presents a unique opportunity for investors.

#### Additional reading:

"Municipal-Debt Fans: 'We've Been Waiting for a Market Like This,'" *The Wall Street Journal*, Monday March 3, 2008, Page C1.

### Unprecedented Dislocation in Municipal Bond Market

