

Municipal Insights



The BMO tax-free income team

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Overview

2014 is likely to remain a challenging period for municipal investors, but we expect to see demand improve as yields rise. We believe flows will stabilize at some point in 2014, but not until rates reach nominal levels that appeal to a broad group of investors once again. As they did last year, investors should manage their duration risk, as rate volatility is likely to be as high, or higher, than it was in 2013. Curve exposure will also be a critical decision for investors and may mean the difference between a positive or negative return for the year. We expect yields to rise in a bear-flattening manner beyond the two-year maturity range, with rates shifting higher but to a lesser degree as you extend along the curve.

From a credit perspective, we think good value can be found in the A rating category. Despite the very visible challenges of a few select municipalities, the backdrop for municipal credit continues to improve and we expect market volatility to increase in 2014. In addition to the challenges the Federal Reserve (Fed) faces in ending quantitative easing, proposed new regulatory restrictions on banks could negatively impact liquidity in the municipal market if enacted. Investors should maintain sufficient liquidity to capitalize on periods of market stress since active management should outpace a passive approach in 2014.

Market commentary

Supply and flows

Total gross supply in 2013 was below 2012 levels, and we expect that total supply will once again decline in 2014. Total supply in 2013 is projected to finish the year at approximately \$320 billion, down from \$370 billion the year before and below the pre-recession, five-year average of \$395 billion. Higher yields reduced the refunding volume in 2013 and fewer refundings still are likely next year. While borrowing for new projects may rise year-over-year, it is not likely to be enough to offset the decline in refunding activity. In addition, the total outstanding supply of tax-exempt debt is expected to decline next year as more bonds are called away or mature than are expected to be issued.

Tax-exempt funds experienced persistent outflows through the last two-thirds of 2013, setting a record both in consecutive weeks of outflows (26 at this writing) and total redemptions (approximately \$60 billion, or 11% of fund assets). The most severe outflows have occurred among long-term and high-yield tax-exempt funds, both of which lost roughly 15% of total assets. We expect the trend of redemptions to continue into 2014 until either investor views change regarding equities, or yields have risen to levels that are deemed broadly attractive once again.

Proposed new bank regulatory rules, if not altered, could have a negative impact on demand for certain types of municipal securities, possibly as early as 2014. Money center banks and large regional banks have been large buyers of longer, higher-quality municipal debt over the last several quarters. If municipals were deemed to no longer meet proposed bank liquidity rules, it could reduce demand for long-term debt. This

proposal will need to be monitored over the course of 2014 for the potential impact on the tax-exempt market, although major tax reform is unlikely during that time period.

Rates and yield curve

Our outlook for higher rates presupposes a stronger pace of economic growth and employment. The fiscal drag from higher taxes and sequester spending cuts will fade, leading to GDP growth above the 2013 pace.

Assuming the Fed continues to anchor overnight rates near zero, a reasonable target yield range for the 10-year Treasury in 2014 would be 3.25% to 3.50%. The steepest slope that has occurred in the past 30 years between two- and 10-year Treasury yields is 290 basis points (bps). If two-year yields stay near current levels (0.30%), this would suggest a 3.20% 10-year Treasury yield. Allowing for some modest upward adjustment in two-year yields, this implies a reasonable yield target of approximately 3.50%.

We expect that 10-year tax-exempt yields would trade between 90% and 100% of Treasury yields based on recent trading patterns. Arguably, tax-exempt yields should rise less than Treasury yields, but until the persistent redemptions from municipal funds stabilize, that may not be the case. This suggests an upper band for 10-year tax-exempt yields would be between 2.90% and 3.50% in 2014. Currently, AAA yields in this range are near 2.75% and the peak 10-year tax-exempt yield was 3.04% on September 5, to put the target range in perspective. Rates would need to rise 45 bps to reach the midpoint of this tax-exempt range.

If the yield curve is going to gradually return to a more normal structure, yields on five-year bonds should rise more than 10-year bonds in 2014. This suggests that five-year Treasury yields could rise by 80 bps next year, which would likely pull AAA tax-exempt yields up by as much as 65 bps from current levels. (Five-year tax-exempts currently trade at roughly 80% of Treasury yields.)

As rates rise, we expect the 30-year segment of the curve to rise less than either fives or tens, leading to a bear-flattening trend. The support for this view is due to the undervaluation of long tax-exempt yields, currently trading near 110% of Treasury yields, as well as the natural demand for tax-exempts at certain target yield levels. One of those target levels historically has been 5.0%. If long-term AAA yields rise to 4.50%, approximately 30 bps above current levels and, interestingly it was also the peak yield reached in 2013, good quality AA and A rated issues will likely be available at the 5.0% yield target. A caveat to this flattening trend is that potential regulatory changes could cause long yields to rise further than otherwise expected.

Credit

Despite the widely reported credit challenges of a few select issuers, the financial condition of most municipalities continues to improve. State tax revenues are now above pre-recession levels, both nominally and inflation-adjusted, after 14 consecutive quarters of growth. Local governments are also on the mend as property values have stabilized or are rising in most regions (the S&P/Case-Shiller 20-City Index is up 13.3% YoY) and sales tax revenues continue to rise as the economy expands. The expense side of the ledger has improved as well. Fiscal austerity was once again evident in recent ballot initiatives across the country while state and local government hiring has only recently begun to occur.

Pension reform efforts are spreading as more than 40 states and many local municipalities have made changes to their pension and other post-employment benefits in an effort to close unfunded liability gaps. Court battles will be ongoing between public sector unions and municipal reform efforts, but sentiment has largely shifted in favor of taxpayers, signaling further alignment of benefits with the ability to fund them is likely to occur.

There is value in A rated issues and select BBB rated issues as spreads remain relatively wide for the improving credit backdrop. The extra yield offered in these rating categories should benefit investors as interest rates rise, helping to cushion any price declines that occur.

Detroit's Emergency Manager is targeting October 2014 as an exit date from bankruptcy, which is a very aggressive time frame. It will likely be 2015, if not later, to sort through the complicated issues involved and to arrive at what the bankruptcy judge and creditors feel is an equitable plan of adjustment. In the judge's initial ruling, which validated the Chapter 9 filing, he stated that federal bankruptcy laws take precedent over state law, allowing for pension liabilities to be restructured if necessary. This should help unsecured bondholder recoveries in whatever ultimate settlement occurs. More broadly, however, this ruling should also give other stressed municipalities an important bargaining tool when negotiating with public sector unions to restructure retirement benefits with public sector unions outside of bankruptcy.

We expect that Puerto Rico's general obligation credit rating will fall below investment grade at some point in 2014, which will contribute to heightened market volatility. The general obligation (GO) rating is currently at the lowest investment grade rating (BBB-/Baa3) by all three major rating agencies, and each has assigned it a negative outlook. So if a downgrade occurs, it should come as little surprise to investors. Yet, because the credit is so widely held by both retail investors and funds, there is sure to be some forced selling when this occurs. In our view, the trading levels for Puerto Rico credits already largely reflect this downgrade expectation, but the type of investors willing to hold this credit is gradually shifting away from retail toward institutional investors. We do not expect Puerto Rico to default in 2014, but it must continue to work to regain investor confidence so they can maintain market access when needed.

Sectors and states

The best performing sectors in 2014 will likely be those that provide a "safe" yield advantage over other sectors, most of which fall into the revenue-bond category. For example, housing bonds typically do well as rates rise, but we also expect hospitals, transportation, water and sewer, as well as sales tax-backed debt to be among the best performers. Select general obligation bonds are also attractive, primarily those where the economy and housing are rebounding strongly.

Geographic themes that will likely continue to unfold in 2014 include the ongoing housing recovery, particularly in Sunbelt states, as well as the tax rebound in strong energy exploration and production states. State and local credits in Florida, Arizona, Nevada, and California are benefiting from solid housing market recoveries. Texas, Oklahoma, and North Dakota are seeing strong sales and related taxes from energy production, particularly fracking activity. Illinois yields are unusually high relative to their ratings and should outperform as the market grows more comfortable with the reform efforts underway.

Strategy summary

Much like 2013, we expect that the total return for both the BMO Ultra Short Tax-Free Fund and BMO Short Tax-Free Fund will be positive for 2014, helped by the stable Fed Funds rate outlook and relatively limited yield rise expected among the very shortest maturities. Return expectations, however, for the BMO Intermediate Tax-Free Fund are more uncertain. Will the yield and very beneficial roll that occurs along this steep intermediate segment of the curve be enough to offset the higher yields we expect? The roll as bonds age along the steep curve may add as much as 200 bps to performance next year. We think the odds suggest a positive return, but only marginally, if yields rise toward our target levels.

We intend to employ several active management techniques to enhance performance this year. One of these tools is the use of both floating- and fixed-rate securities across all our strategies. While the full advantage of the floating-rate securities won't be realized until the market begins to anticipate a tightening by the Fed is near, we view the "cost" of maintaining floating-rate exposure as relatively low given the low absolute levels of short, fixed-rate bonds and the rich levels at which they are currently trading.

A second active tool is credit management. We expect to benefit from the extra yield available among A and select BBB credits to help insulate portfolios against price declines. While we don't expect credit spreads to compress much in 2014, given the ongoing headline risks that Detroit and Puerto Rico present to the market, we also don't expect wider credit spreads since the economy and the macro-credit picture continues to improve.

Third, we will look to capture the opportunities in strengthening states and sectors. The cyclical support within certain regions and sectors should enhance performance through diligent security selection and review.

Finally, given the expectation for higher volatility, we intend to maintain sufficient liquidity across our strategies. Having the ability to capitalize on periods of illiquidity and market dislocation should present total return opportunities for active investors.

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