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The Fork in the Road

Why Are We Buying Corporate Bonds in Municipal Portfolios?

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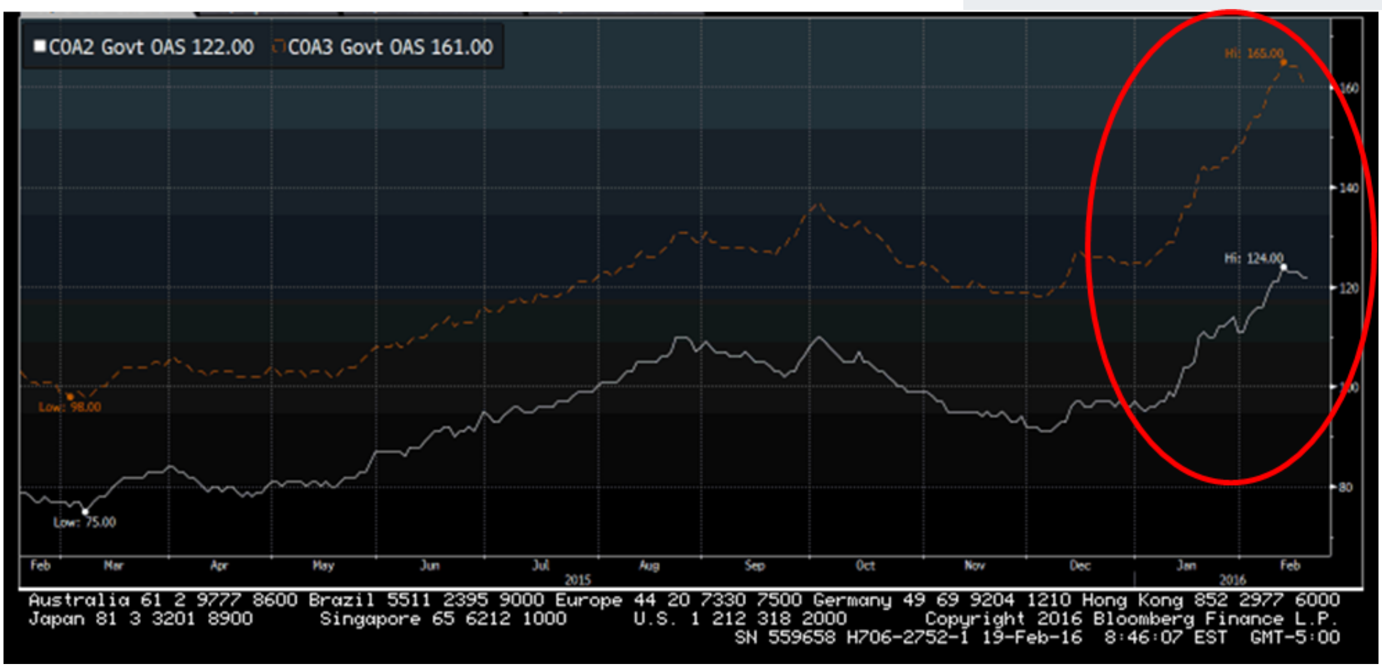
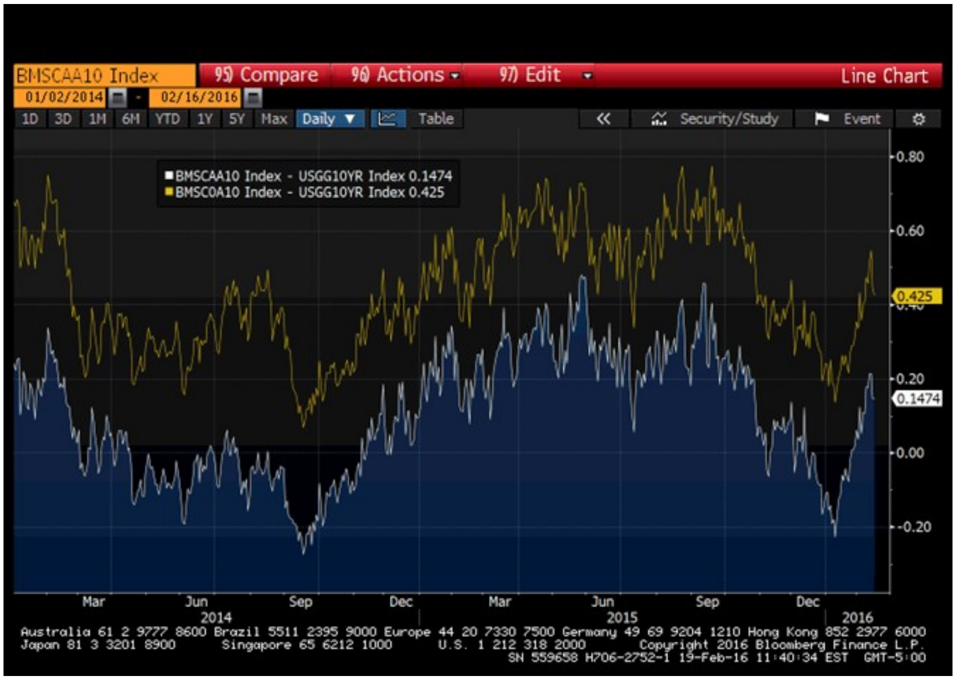
As you may have noticed, we're purchasing taxable corporate bonds in accounts which are typically biased towards holding tax-exempt municipal debt. So why are we diverging from a long held strategy? The rationale behind this lies in the divergent paths of corporate and municipal bond credit spreads.

A bond's yield spread - the additional yield it offers compared to a risk-free Treasury of equivalent maturity – primarily reflects the market price of default risk. Recent concerns about the US economy, a China slowdown, the price of oil, etc., have negatively impacted investor sentiment and perceptions of future growth. In turn, this has led to lower corporate bond prices and higher yield spreads. This feedback mechanism is apparent in the below chart, which shows AA-rated and A-rated taxable corporate bond spreads over time. Since the beginning of 2016, spreads have dramatically widened to multi-year highs, with clear differentiation between increasing tiers of risk.

Corporate Bond Spreads



White = AA-Rated Corporate Bond Spread to Treasuries
Orange = A-Rated Corporate Bond Spread to Treasuries
Source: BofA/Merrill Lynch Corporate Master Indices/Bloomberg, as of dates shown



White = AA-Rated 10-Year Municipal Bond Spread to Treasuries
Orange = A-Rated 10-Year Municipal Bond Spread to Treasuries
Source: Bloomberg, as of dates shown

The same trend is not apparent in the municipals sector. The adjoining chart shows that 10-year tax-exempt municipal bond spreads declined to near multi-year lows at the end of 2015. While they have since rebounded to their recent average levels, this makes for an unflattering comparison next to the significant spread-widening seen in corporate bonds.

Importantly, the actual yields being offered on municipals have declined to nearly the lowest levels on record. From September-November, we were purchasing high-quality, 8-10 year callable munis with yields of 2.90-3.40%.

Today, similar munis are only available at yields ranging from 2.50-2.80%. At the same time, the yields on AA and A-rated corporates (such as Chevron and JPM Morgan) maturing within 7 years have increased from 2.35-2.60% to 2.80-3.45%. We like the added liquidity of corporate vs municipal bonds, and now we have an opportunity to enjoy that improved liquidity without sacrificing yields on an after-tax basis.

Relative levels of municipal interest rates – as measured by municipal/Treasury yield ratios – also remain disappointing. A municipal/Treasury yield ratio trending higher signals better value in municipals, and vice versa. While the 10-year ratio is now more favorable than December's levels, it also remains at merely its recent average value.

A-Rated 10-Year Municipal/Treasury Ratio
Source: Bloomberg, as of dates shown

Summary

The flexibility to adapt in the face of evolving market conditions is a crucial part of our fixed income investment strategy. As relative value investors, we seek to capture the most attractive risk-adjusted returns to help advance client objectives. As a result of these trends, we believe corporate bonds currently offer superior risk-adjusted returns compared to municipals, even taking into account the benefit of the municipal tax-exemption. We are making investment decisions that reflect this belief, and if and when conditions change, we will modify our tactics accordingly.

As always, we welcome questions or feedback, and are happy to discuss how this affects your portfolio.