LPL RESEARCH

BOND MARKET PERSPECTIVES

September 20 2016

MUNICIPAL SUPPLY SURGE

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KEY TAKEAWAYS

The municipal bond market is dealing with a surge of supply of epic proportions, both from new issuance and existing supply in the secondary market.

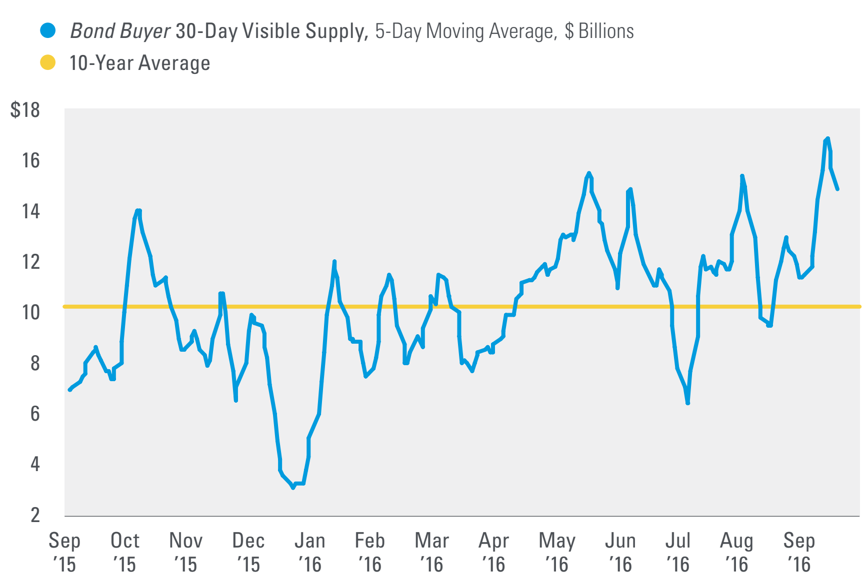
Historically, supply surges have often led to imbalances that resulted in price declines, but municipal bond prices have only showed minor cracks so far.

Supply remains a negative overhang in the near term, but several other catalysts would likely be needed for a more severe pullback.

Record new issuance for August has carried over into September and may be finally weighing on municipal bond prices. Supply surges have often led to imbalances that resulted in price declines, but municipal bond prices have only showed minor cracks so far. The *Bond Buyer* 30-day visible supply calendar (using a five-day moving average to smooth data) shows how new issuance surged in September 2016 [Figure 1]. On September 13, 2016, the 30-day calendar jumped to a record $19.2 billion, surpassing the prior peak in 2014. August 2016 witnessed record new issuance for the month, typically a very quiet month for new bond supply. The surge in new issuance has carried over into September and is only now showing signs of decelerating, but it remains elevated.

Not only has new issuance surged, but so has secondary market supply. The dollar amount of bonds looking to be sold, known as bid-wanteds, spiked higher—consistent with levels that often accompany periods of municipal bond weakness [Figure 2]. Many of these bonds have made their way to dealer inventories, with their measures also at highs, according to Bloomberg data.

1 **NEW MUNICIPAL BOND ISSUANCE HAS SURGED**



Source: LPL Research, *Bond Buyer* 09/19/16

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If broad bond market pressure continues, bloated dealer inventories could exacerbate any price declines as they may be reluctant to take on additional bonds.

In the past, such episodes of high new issue supply, secondary supply, and rising dealer inventories have corresponded to municipal weakness. The municipal bond market is less liquid than many segments of the high-quality taxable bond market, making it more susceptible to supply swings.

FORCEFUL FLOWS

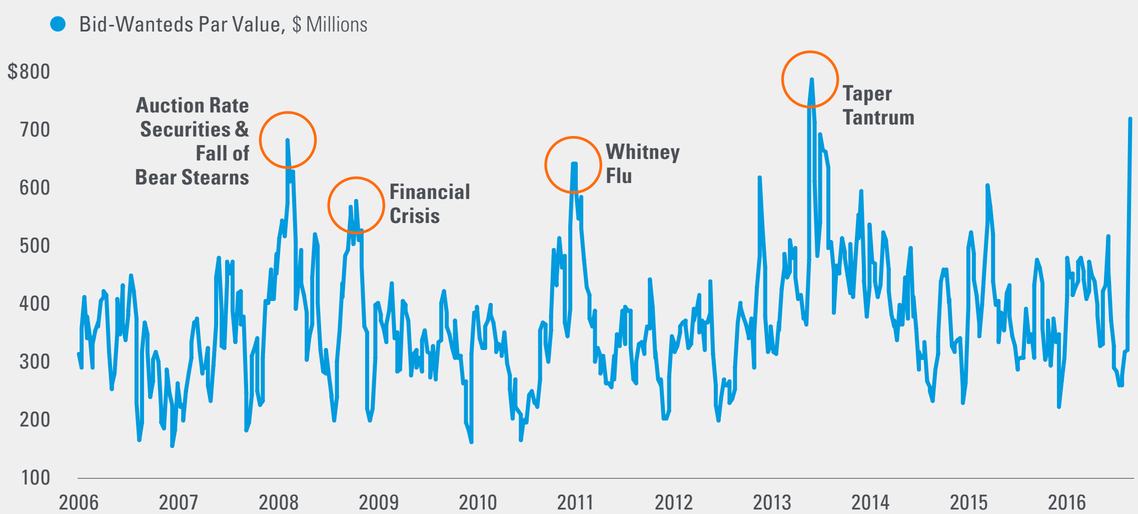
Strong investor demand has offset the potential impact of surging supply. Inflows into municipal bond funds have been positive for a remarkable 49 straight weeks according to Investment Company Institute (ICI) data. Flows have been not only positive but forceful, with inflows exceeding $1 billion per week for every week going back to late April 2016, with only two exceptions. Year to date through September 7, 2016, ICI municipal mutual fund inflows total a hefty $49 billion. Compare that with recently released Federal Reserve (Fed) data, which show the municipal bond market grew by $50 billion from January through June 2016.

Growth in the outstanding supply of municipal bonds has been almost completely absorbed by mutual fund investors alone. Including other classes of investors, such as banks (which increased municipal holdings by $25 billion), individual investors, and institutions, we can see the impact of demand absorbing supply.

VALUATIONS SHOW STRESS

The offset of strong demand to surging supply helps explain why municipal-to-Treasury yield ratios, a measure of valuations, remain on the expensive side of a three-year range [Figure 3]. Note that both average 10- and 30-year ratios have crept up in

2 PERIODS OF MUNICIPAL PRICE VOLATILITY ARE OFTEN MARKED BY A SURGE OF BID-WANTEDS



Source: LPL Research, Bloomberg 09/19/16

Bid-wanteds represent bonds seeking prices for potential sale on Bloomberg's trading platform.

Performance shown is historical and no guarantee of future results.

recent days, suggesting the municipal bond market is beginning to reflect the pressure of surging supply.

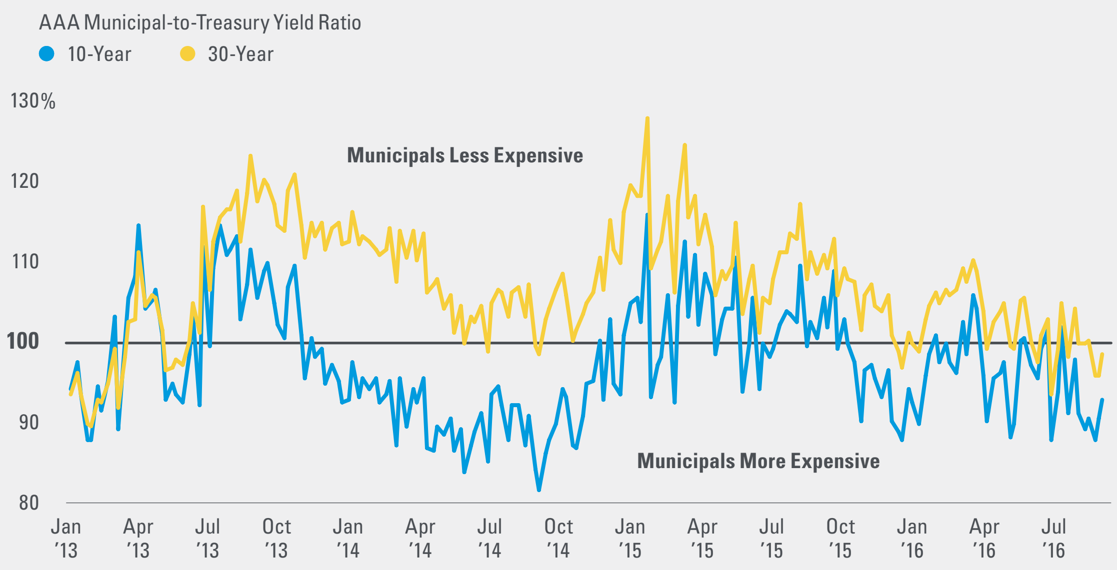
THE FED & BANK OF JAPAN

Recent municipal weakness reflects broad bond market weakness in response to a combination of hawkish commentary from Fed officials, European Central Bank (ECB) and Bank of Japan (BOJ) comments, and increased expectations of fiscal stimulus both domestically and in Japan. Treasury prices have moved lower ahead of this week's key Fed and BOJ meetings and have taken much of the bond market with them. Municipal weakness in recent weeks has been largely a result of broader market movements and not a result of the supply flood.

CONCLUSION

An unexpected Fed rate hike on Wednesday, September 21, could be the catalyst that crimps investment demand and causes heavy supply to push prices lower and yields higher. However, we view a rate hike as soon as this week as unlikely (see this week's *Weekly Economic Commentary*), and heavy supply as having only a near-term impact while investor demand remains elevated. We expect that absent an economic shock or unexpected spike in rates that damages investor perceptions of the municipal market, continued strong investor demand may help to offset headwinds of increased issuance and fair-to-expensive valuations, leaving us neutral on the asset class overall. ■

3 VALUATIONS HAVE CHEAPENED IN RECENT DAYS, BUT REMAIN ON THE EXPENSIVE SIDE OF A 3-YEAR RANGE



Source: LPL Research, MMA, Bloomberg 09/19/16

Performance shown is historical and no guarantee of future results.

Yield ratio is a comparison of the expected yield of one bond to the expected yield of another. The ratio of municipal bonds to U.S. Treasuries is a common barometer of municipal bond valuations.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

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