» PORTFOLIO MANAGEMENT

Get 'em while they're hot

The supply of bank-qualified muni stocks remains low.

By Jim Reber and Justin Sparks

If your community bank owns tax-free securities, and we hope it does, your portfolio manager has probably had to work extra hard lately to find bonds with acceptable qualitative features in acceptable quantitative block sizes. This is the result of ever-expanding demand and stagnant, at best, supply. But once again, since we're in the double-edged land of fixed-income investing, this is both a problem and a solution.

You veteran community bankers have come to understand that the municipal bond market, as a segment of the global debt securities world, has some nuances. These nuances expand when we drill down into the bank-qualified (BQ) subset of the muni market. And lately, we've reached some supply thresholds that have broken through historical norms.

Calendar cycle

First, let's recall that the BQ segment comprises only about 7 percent of the $3.6 trillion muni market. The reason community banks are predisposed to investing in these dear securities is that they are further tax-advantaged over general market munis.

The problem with BQ bonds is the quantity, because an individual BQ issue can be no larger than $10 million. Obviously, there are many essential-service projects that require much more than $10 million, so small issuers will often time their launches to comply with these limits.

This produces the "December effect" and its corollary, the "January effect." The BQ market is swamped with supply each calendar year-end, which causes prices to temporarily drop. Many savvy investment managers are buyers of BQs prior to each year-end. At the start of each year, there is typically a dearth of new issues, which can cause muni prices to rally.

Aggravating the January effect is the fact that January 1 is by far the most common date for munis to mature or be called. This puts still more dollars in search of tax-free homes at exactly the point in the muni cycle when precious little is being created. The second most common roll-off date is July 1, and midyear is still typically a quiet time for BQ issues, so it's not uncommon to see muni prices improve in that window.

Less can be more

The graph to the right shows the "net supply" in the municipal market over the past two years. Net supply is the difference in bonds maturing and being issued in the next 30 days. One can readily see that each midyear has a huge net negative supply. The takeaway from the graph is the municipal bond population is shrinking, and there are periods each year when the shortfall is especially acute.

What is interesting is that the rally in municipal bonds in the first half of 2017 has primarily been credited to the right-sizing of investor expectations relative to Trump administration plans for stimulus spending and perhaps tax reform. The data in the graph would tend to suggest that market fundamentals

Education on tap

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ICBA VOICE

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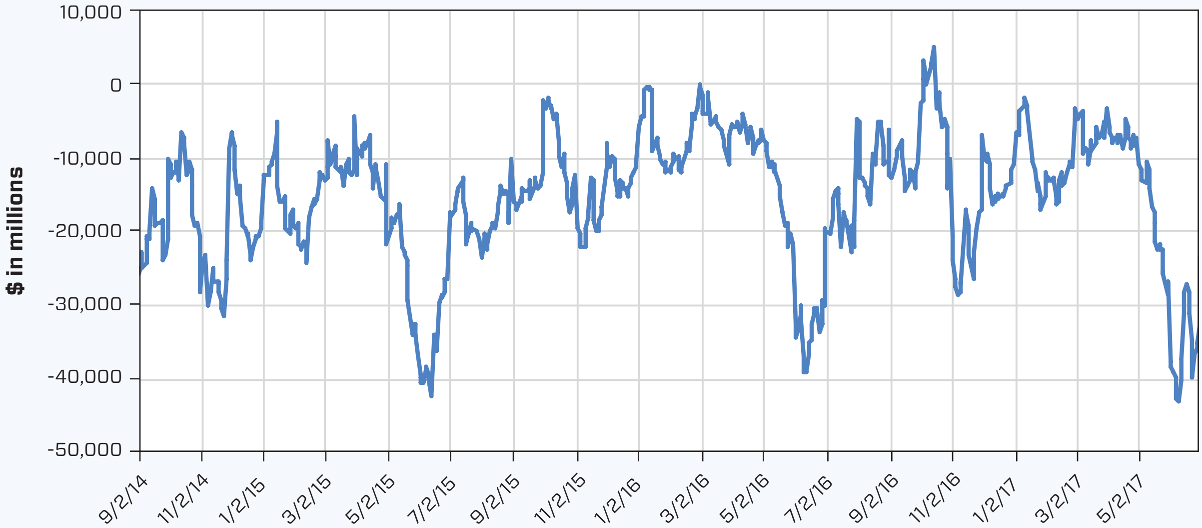
Municipal bonds: 30-day net supply



Source: Bloomberg

are pushing yields down and, consequently, prices up. For the record, in the first half of 2017, the yield on the 10-year Treasury note fell about 15 basis points (0.15 percent), while 10-year municipal bond yields fell about 35 basis points (0.35 percent).

What to do

Until Congress gets around to looking at permanently expanding the size of the BQ sector, it would appear that there will continue to be some support for muni prices simply from the growing demand. Community bank earnings, both at the individual bank level and, certainly, industrywide, are expected to grow, thus creating a larger pool of earnings from which to avoid taxes.

So the advice is to, within reason, increase your community bank's allocation to tax-free bonds. The "within reason" caveat includes consideration of cash flows, interest-rate risk and liquidity. Of course, we must keep in mind the due diligence required by Dodd-Frank.

Still, the wide-scope picture for supply-demand of the BQ muni market bodes well for community bank investment portfolios. IB