Municipal Market Comments

Ascent Investment Partners

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2013 Municipal Outlook

As we begin 2013, the municipal market remains near historically low yield levels. The immediate impacts of the year-end "Fiscal Cliff" theatrics in Congress were largely positive for municipal bonds, if only for the immediate term. Investors looking for longer-term clarity have been left unsatisfied, as the potential for sequester-related impacts have merely been delayed by two months. Moreover the looming fight over the federal debt ceiling promises to ignite another round of political wrangling that could again raise market concerns about the integrity of the U.S.A.'s triple-A credit rating.

At the start of 2012, yields for 10-year AAA municipal bonds were 1.88% while 30-year AAA yields were 3.57% (as reflected by the Municipal Market Data yield scale). Municipal yield levels declined dramatically during 2012, touching historic low yield levels in November, then backed up modestly through the end of 2012, reflecting concerns over the potential for changes in tax treatment of municipal bonds. On Dec. 31, 2012, 10-year AAA municipal bond yields were 1.72% and 30-year AAA yields were 2.83%.

Most of the major investment banks are forecasting AAA municipal yields will rise in 2013 by approximately 25 basis points (25 bps, or 0.25%) in the 10-year maturity range and by between 25 bps and 50 bps in the 30-year maturity range. The projected rise in rates reflects expectations that U.S. Treasury rates will rise modestly and that the ratio of municipal yields to Treasury yields will remain static.

While we do not forecast rate levels, our expectation is that municipal market yields will rise over the next 12 to 24 months. It is entirely possible in the near term that political pressures could cause sharp rallies in credit markets, including municipals. Longer-term, however, the Fed will move to a tighter monetary policy that will force rates to move in the direction of historical averages.

Although there are a number of factors that will affect how the market moves on a day-to-day basis, we believe that municipals will continue to be largely driven by the interplay of macro forces arising from discussions on tax policy and Fed monetary policy. Trends in issuers' credit quality and fundamental municipal market supply/demand characteristics will also affect rates. Specifically:

- ***Tax Increases Make Munis More Attractive.*** The year-end tax agreement reintroduced a top income tax rate of 39.6% in 2013 for individuals earning more than $400,000 ($450,000 for joint filers). The bill also phases out some deductions for higher income taxpayers. Additionally, the 3.8% investor surtax included in the Affordable Care Act of 2010 took effect on January 1, with tax-exempt interest income a notable exclusion. Taken together, the tax increases are widely expected to spark demand by high-income investors for municipal bond investments.

- ***Fed Policy Expected to Remain Steady for Now.*** Near-term, the Fed continues to signal its commitment to extremely low interest rates and continued bond buying. Though we cannot predict the timing of changes in Fed policy, there appears to be very little the Fed could do to drive rates down further. However, there is the potential in late 2013 and into 2014 for policy changes that could begin to push rates higher.

- ***The Fiscal Cliff and The Debt Ceiling Could be Drivers for Tax Reform or BABs Redemptions.*** The year-end agreement on taxes pushed the debate on automatic Federal budget cuts out two months. In the same timeframe, Congress will reengage the debate over the Federal debt ceiling. Investors continue to be concerned that any large-scale tax reform or expenditure reduction could include changes to the tax treatment of municipal bonds (we discussed these prospects in more detail in our Dec. 17, 2012 *Municipal Market Comments*). The possibility also remains that cuts to Federal interest subsidy payments on Build America Bonds (BABs) could trigger redemptions of some issues (we will discuss this in greater detail in next week's *Comments*).

- ***Municipals Credit Quality Starting to Improve.*** Municipal issuers have largely weathered the economic difficulties brought on by the recession. Public pension funding continues to be a long-term issue that will have to be addressed by many state and local governments. Certain individual municipalities also face significant financial pressures that could generate headlines in 2013. Even so, most state and local issuers have stabilized their budgets and maintained their credit quality.

- ***Muni Supply Expected to Increase.*** Municipal market participants generally expect the issuance level of new bonds to grow in 2013. As issuers' financial health improves, they are more likely to undertake more capital borrowing that may have been delayed when budgets were shrinking. Likewise, at current market levels, issuers are actively seeking to refund outstanding, higher-coupon bonds to achieve savings, and many will want to move quickly if they think that rates will increase later this year or in 2014. Though large increases in issuance can strongly influence market rates day-to-day or week-to-week, given the current tax environment we would not expect an increase in issuance, by itself, to have any significant effect on rate levels.

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