MUNICIPAL FIXED INCOME

Municipal Fixed Income is a separately managed account investment strategy

Commentary – 6/30/2019

- Favorable yields to state and local municipalities bringing new issues to the market grew by $104 billion for 1H19, a 14 percent increase over last year.
- The short end of the maturity curve offers the greatest possibility to buy an out of state bond at a lower price and still yield slightly better after factoring the state and local tax.
- A rebound to 80.576% for the quarter end 2Q19 shows the increased volatility in the bond markets.

While the Tax Reform Act is affecting everyone, those in high income tax states are especially affected due to the State and Local Tax deduction that is capped at $10,000. The demand for tax exempt municipal bonds has increased at a level greater than other periods in recent history. High tax states including, but not limited to, California, New York, New Jersey, and Connecticut have witnessed individual investors buying greater quantities of municipal bonds in an attempt to reduce the increase in tax liability. The concentration in high tax states to purchase municipal bonds have driven prices to an extreme, resulting in lower yields, to a point where these investors should look to buy a municipal bond of a state outside of their home state. The short end of the maturity curve offers the greatest possibility to buy an out of state bond at a lower price and still yield slightly better after factoring the state and local tax.

With more individuals sourcing tax exempt municipal bonds for fixed income needs, the municipal bond sector produced the best first half return since 2014. Impressive demand of 25 consecutive weeks of inflows that outstripped supply forced prices higher and yield lower which gave local and state municipalities the opportunity to offer new issuance at lower costs. Favorable yields to state and local municipalities bringing new issues to the market grew by $104 billion for 1H19, a 14 percent increase over last year. Historically more bonds mature and are called than new issuance coming to the market between June and August, which is estimated to possibly be $117 billion, which could support the higher levels until 3Q19. In addition, political events such as trade tariffs and global slowdown of GDP are adding support of lower yield levels.

The rapid increase in prices in 1H19 brought undesirable comparison with comparable Treasury yields. 10 year municipal bond yields declined to a level of 74.364 percent of comparable Treasuries in April 2019, the lowest percentage since 2001. A rebound to 80.576% for the quarter end 2Q19 shows the increased volatility in the bond markets. The historical average is 85 percent municipal yield to Treasury yield. In 4Q18, the yield ratio comparison was 92 percent of municipal bond yield compared to Treasury yield. That is a considerable change, both directions, in a relative short period of time. Crossmark Global Investments Municipal Fixed Income team will be selectively buying bonds as prices normalize. Contact Crossmark Global Investments for an updated version of "Volatility in the Bond Markets Highlights Advantages for Municipal Bonds" White Paper.

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Lower yields, fewer bonds coming to the market than are being redeemed through maturities and called features, anticipation of a Federal Open Market Committee (FOMC) Fed Funds rate cut and a desire to own tax exempt income have driven individual investors to buy longer term maturities and higher risk bonds. This search for more yield may work in the short term as interest rates drop and inventory shrinks during the seasonal summer period with speculation of a rate cut fuels the desire for lower quality, longer maturities and higher risk. Municipal bonds considered to be riskier are being bought immediately upon availability to in the market. This is being demonstrated globally as purchases of long maturity and lower quality bonds reach a very high level. Investors that are thinking they are buying a one way move to lower interest rates may get an unpleasant surprise. Even if the FOMC keeps rates low or possibly even cut the current Fed Fund rate, the fixed income markets may begin to consider central banks effectiveness of monetary policy. If economic benefits do not develop then credit risk may get priced in and if economic numbers improve then inflation may become an issue. Going longer duration now that the 10 year Treasury is merely 50-60 basis points from the historic low of 1.38% seen on July 5, 2016 could be favorable in the short-term but may be a disappointment in the future.

Crossmark continues to find value in the municipal secondary market with bonds rated A or better involved with essential services like water, sewer, power, streets, highways, school education and general obligations. The ideal maturities on the yield curve have moved to the 10 to 20 year range with a call feature between 2022 and 2025. Crossmark continues to hold a shorter duration than the Barclay's Quality Intermediate Municipal Index with a focus on higher quality municipalities. Crossmark continues to use municipal bond market volatility to opportunistically manage the portfolios entrusted to us.

Our Firm

Crossmark Global Investments is an innovative investment management firm. We provide a full suite of investment management solutions to institutional investors, financial advisors and the clients they serve. We have a multi-decade legacy of specializing in values based investment strategies for clients. Founded in 1987, the firm is headquartered in Houston, Texas and manages approximately $5.0 billion in AUM.

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