The municipal market – what to expect in 2017

Nicholas Sourbis, Managing Director, National Public Finance Guarantee

Municipal bonds, the primary source of capital for our nation's state and local governments and their agencies, have historically provided investors with safe and relatively stable investment returns. While credit stress can occur, as in the cases of Chicago and Puerto Rico for example, these situations are rare, although newsworthy. The vast majority of municipal securities are low-risk and enable individuals to invest directly in their local governments, often earning a tax-advantaged return on capital. In 2016, there were strong investment opportunities in the muni bond space, and record new issuance. In 2017, we expect there to be lower issuance, and perhaps greater volatility. Wealth managers and high net worth advisors interested in taking a look and investing in municipal bonds for their clients should be aware of the evolving market dynamics.

Municipal bond issuance in 2016 was an all-time high at $445bn, exceeding the previous high of $443bn set in 2010. Refundings, mainly driven by a low interest rate environment, were a key impetus to the substantial increase in total issuance as new money continued to lag a bit due to budgetary and other concerns at state and local government levels. These refundings of debt issued roughly a decade or so earlier allowed issuers to realize significant cost reductions as they were able to refinance the debt at significantly lower interest rates. Muni bond performance, which was on a bit of a downward trajectory closer to year-end due to increases in interest rates and a reversal in fund flows, ended in positive territory. By most estimates, fund flows into municipal bonds ended the year with a positive $26bn.

Some themes for 2017

Volatility should remain a significant issue for the municipal market in 2017, and despite a relatively strong economy, municipalities across the U.S. continue to grapple with a number of challenges – including reduced federal and state aid, ballooning pension and OPEB liabilities, and the possibility of tax reform.

Issuance expectations for 2017 should be scaled back versus 2016's record year – many analysts, in fact, expect issuance to drop to the $360-$390bn range with a variety of factors at play, including:

- A decline in refunding activity due to the expected increase in interest rates, making refundings less economical, as well as a lower amount of refundable deals remaining. Conversely, new money issuance is expected to increase at modest levels.
- Uncertainty resulting from the new administration and potential changes in the tax code, tax exemption for municipal debt and unknowns around potential infrastructure investment.

From a credit perspective, we expect a continued focus on public pensions, a growing issue/problem as more and more government agencies grapple with the conflicting obligations to creditors and pensioners. Rating agencies and credit analysts will likely increase their focus on those issuers that have large and growing unfunded obligations. Political pressures have resulted in pension obligations faring better than one might have expected relative to debt in the settlement of several recent high-profile municipal bankruptcies and, as issuers' willingness to pay increasingly comes into question, market professionals must remain wary of pension liabilities that continue to grow.

Infrastructure spending and investment, which has historically mainly been financed through the municipal market, has been gaining increasing attention as a potential driver of greater municipal bond issuance particularly given President Trump's stated goal to substantially invest in our nation's roads, bridges, and airports. The critical question for the municipal market will be the final form of any new program and the timing of any new legislation. Any bipartisan legislation on infrastructure investments will take time to be finalized, and any legislation may be more focused on debt and other investment that is not directly correlated to the municipal market. While we don't yet know how, or if, this investment will translate into new muni bond issuance, it could be a future investment opportunity.

The bottom line and consideration is this for wealth managers and high net worth advisors: volatility appears to have crept into the municipal market, causing some uncertainty and likely leading to the increase in fund outflows toward the end of 2016. Despite these near-term issues, we anticipate that the muni bond market will remain robust.