Municipal Bonds May Be An Attractive Investment Option Post Brexit

While there is no precedent for assessment of the fall-out for the UK or the global economy from the decision to exit the European Union (EU), we believe the US municipal market will be a ray of stability, if not an investment opportunity in a post-Brexit world. Uncertainty around the leadership, cooperation or success that the British government will face in renegotiating trade agreements serves as a dead weight for risk-taking in financial markets and capital investment. We believe the Federal Reserve, which showed itself sensitive to global economic and financial risks earlier this year, will delay again its anticipated policy tightening until later this year. High quality US fixed income instruments, including municipal bonds, may benefit from a global flight to quality as the “leave” decision is implemented and unintended consequences unfold.

As investors seek relative safety post Brexit, we believe municipals present themselves as an attractive investment option to preserve capital in a world of expected higher volatility. The US municipal bond market continues to offer strong credit quality, a relatively high income stream and price stability for global investors. Market technical factors are also positive amidst a favorable demand/supply backdrop. Investment flows into the market have been very supportive with over 38 consecutive weeks of positive inflows to municipal mutual funds. The net supply of municipal bonds is also relatively limited over the near term, not keeping pace with investor demand and accommodation of coupon reinvestment. Standish believes that municipal bonds are currently priced fairly relative to US treasury bonds and may become more attractive if the strong treasury rally continues.

Municipal credit conditions, on balance, are expected to remain stable following the Brexit vote. State and local property tax revenues have rebounded in recent years, in part buoyed by the stimulative impact of lower oil prices and appreciating housing values. Oil dependent states, including Alaska, Louisiana, North Dakota and Texas are
notable exceptions. With Brexit-inspired oil price declines, we expect to see further improvement in revenue sectors that are dependent on oil consumption, including toll roads, airports and hospitals. The municipal tobacco sector has also benefited from cheap gasoline prices and may continue to be a strong performer. Areas of concern continue to include states with poorly funded pension systems and states that are heavily dependent on capital gains receipts; a US stock market sell-off has adverse impact on assets and revenues.

Standish continues to favor revenue bonds over general obligation debt and look for opportunistic trading opportunities where relatively cheap valuations are inconsistent with fundamental views and technical conditions. Our portfolios are positioned to deploy ample liquidity to buy bonds in the event that we see selling off beyond fair value. Thus far, the municipal market has operated cautiously with an absence of panic selling. Standish is actively seeking to take advantage of opportunities as the markets adapt to the realities of Brexit.