Muni Bonds

The Perfect (Municipal Bond) Storm... and How to Profit From It

Economy & Markets Daily

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The recent wave of selling in fixed income has been indiscriminate. Like a ship at sea in a storm, if it wasn't nailed down it got thrown overboard. Treasuries sold off, with the 10-year Treasury bond falling faster than at any time but in the depths of the financial crisis. Joining in the carnage were corporate bonds, junk bonds, emerging market bonds, and municipal bonds (muni's). A typical decline was 10% of value in just a matter of weeks. The issue that sparked the crisis was the Fed's announcement of a possible end to its bond buying program, which sent yields up across the board, hurting all fixed income. We have been warning about a bubble in bond prices (courtesy of the Fed) for some time, and have even held a short position in JNK, a junk bond index, in our portfolio to profit from the eventual decline in this market. However, just like with a ship abandoning cargo, in this financial storm many things of value ended up underwater. We are not fans of corporate bonds or junk bonds at this point, but we do recognize that the selling in municipal bonds has been overdone. However, this is not a simple case of interest rates…there is more to muni bonds that just higher yields.

When it comes to municipal bonds, we have to consider not only the bonds themselves, but also the environment in which they exist.

Learning the Bond Game

Over 20 years ago, as a young gun on Wall Street, I rolled out after two years at a major firm to get my MBA. Wanting to keep my hand in the game, I got a transfer from New York to Dallas, where I attended SMU. The local office was a regional trading desk that handled muni bonds. I didn't have much experience with muni's, but how hard could it be? As usual for that age, I was long on confidence and short on knowledge.

I immediately learned from the older and much wiser people on the desk that there were two key strategies to winning when trading municipal bonds.

Strategy #1: Pay Attention to Rates

The first strategy is "don't fight the Fed." If the Fed is in an accommodative stance, then they are making money cheaper, hoping to stimulate the economy. This calls for falling interest rates, which makes bonds more expensive. In such an environment, the goal is to be aggressive when bidding for bonds, particularly in the weeks and months immediately following the first Fed "easing." By purchasing a lot of bonds in a falling interest rate scenario, a trader will have the advantage of holding inventory that increases in value. The goal is never to hold inventory for a long time — we were traders, not investors — but having a tailwind of inventory that grows in value is a darn good thing! The opposite of this is also true. When the Fed is restricting money supply interest rates are typically rising. When this happens a bond trader wants to hold as little inventory as possible (prices are falling, so why hold it?) and to be very cautious when bidding on new inventory. If you happen to win a bid, you want to make sure that you own the bonds at such a price that they can be moved very quickly.

The action steps to take when the Fed is easing or tightening are clear. The problem is, what do you do in between? If a Fed policy is long in the tooth, then chances are they will change soon, which could leave a trader with either lost potential (you didn't hold enough inventory) or outright losses (you held too much inventory), depending on the new direction.

What the Fed Just "Said"

While the Fed itself is an institution and doesn't talk much, the members of the Federal Reserve Board of Governors can certainly hold their own in conversation! From Janet Yellen's press conferences after the scheduled meetings adjourn to the various speeches by Fed Governors, there are many opportunities to get an idea of what the members of the Fed are thinking. Right now, it is clear that the governors are in full retreat from any notion of pre-recovery tightening of monetary policy.

The markets were on edge after the minutes of the April meeting were released because the possibility of ending the bond buying program was raised. When the June meeting ended with a statement that also included the possibility of tapering Fed bond buying, the fixed income markets went into a tailspin. This was followed by a week of Fed governors telling anyone who would listen, "Not yet." They won't take any action to stem bond buying until the economy strengthens. With measures like manufacturing surveys, industrial production, and GDP all showing that our economy remains weak, we think that the Fed will not take moves to reduce their bond purchasing for many months. This means that yields on high quality debt — not junk, mind you — should fall, so that the bonds appreciate in price.

Strategy #2: Investigate

The second strategy is to gain credit knowledge, or do enough research to know exactly what is the payment stream that stands behind every bond you purchase. Some are simple — general obligation bonds are payable by the full faith and credit of the issuer, toll road bonds are payable from the tolls collected. Some are hard — redevelopment zone bonds are payable from the future taxes of a few city blocks where the bond proceeds are used to renovate, while tobacco settlement bonds are payable from restitution pledged by tobacco companies to the states. If the backing of a bond is simple, then estimating its value is fairly straightforward — it is a combination of the credit quality, interest rate environment, etc. If a bond has "hair," meaning the backing of the bond is murky or is hard to calculate, then estimating the value is a lot harder. IF a trader (or an investor) is willing to spend the time and effort delving into the backing of bonds that are somewhat obscure, then he will eventually be rewarded by finding a bond that is trading below its intrinsic worth, given the financial backing of the bond. The reason is, most people simply won't put in the time to look.

Lately, a lot of previously clean bonds look like they've grown a lot of hair!

City bankruptcies are no longer a possibility they are a reality. Stockton, CA, San Bernardino, CA, the capitol of Pennsylvania (Harrisburg) — these cities have all gone under. At the same time, some large districts like the Sewer program in Jefferson County, AL (Birmingham) are in trouble. But the biggest question mark in the U.S. today is Detroit. Motor City had an Emergency Manager (EM) appointed by the state because the city is effectively bankrupt. The EM opened up a dialogue with creditors of the city — from vendors to bondholders to pensioners — to let them know that everyone would feel pain. For the municipal bond holders that own Detroit general obligation debt as well as water and sewer revenue bonds, there will be losses. The question is, "How big are the losses?" This is a very strange situation because the city has bonds outstanding that are backed by its unlimited ability to raise taxes, so they would seem to be safe. Unfortunately, as Detroit has found out, there really is no such thing as "unlimited." With citizens moving out and property tax revenue dropping like a rock, there is no conceivable way to raise taxes on the remaining people and businesses to the level that would be required to repay all the debt.

The situation in Detroit — along with the other cities mentioned — sent shockwaves through the muni bond market. Suddenly investors are (rightly) asking if issuers like the state of Illinois will pay their debt? Illinois has less than 50 cents on the dollar of what it needs to pay its retirees. Will the state choose to let retirees go under while continuing to make full payments to those rich bond holders? These sorts of questions are going through the minds of traders and investors alike, casting a pall over the muni bond market.

While these issues are large and thorny, they are also a wonderful opportunity for investors. While so many people are looking at the negative side of the muni bond market when it comes to credit worthiness — who has the money and the will to pay — they are shying away from the market in general. This leaves a lot of value on the table for people who are willing to look.

I looked through the inventory offered by my online brokerage firm and found a North Texas Tollway Authority bond that pays no interest (so I would buy it at a very deep discount) and matures in 2034. (NOTE — This is not an offer to sell a security nor an endorsement of a security, this is simply for illustrative and educational purposes!) The bond is backed by the toll payments in the Dallas, TX area, and also have an insurance policy from Assured Guaranty. The bonds currently yield 5.02%. Keep in mind that is TAX FREE. I was able to look up what payment stream was behind the bonds, the history of the issuer, as well as recent trades on these bonds to make sure the offering was not out of line. All of this information on muni bonds is available for anyone who wants to look on a website called EMMA — Electronic Municipal Market Access (emma.msrb.org).

For those that want interest semi-annually, instead of letting their investment compound over many years, I found a bond that was issued by the Bryan, TX Electric authority. The bonds are backed by electrical payments in the city of Bryan, which is adjacent to College Station, TX, the home of Texas A&M University. This electrical authority has 3 times the coverage needed to make the bond payments and has $65 million in very conservatively invested funds. This particular bond pays 4.125% and matures in 2037. It is priced at 4.00%, so a buyer would pay just over $1,000 per bond. The Bryan, TX electric authority is highly rated on its own at A1/AA, given its very strong financial position. Again, all of this information is available to anyone on the EMMA website.

The yields on these securities — 5.02% for a 21-year bond and 4.00% for a 24-year bond — might not sound like a lot, but the broader trend in the U.S. economy makes them golden…anyone with assets is facing higher taxes.

The Clamor for Assets

The last four years have seen as steady onslaught of legislators looking for ways to take more wealth away from private citizens. The most direct method, taxation, got a boost in early 2013 as the income tax rate for higher earners was moved up. Whether or not this is a good thing can be set aside for a different time. For our purposes, this simply means that the good deal afforded to investors by purchasing muni bonds just got better!

From 2001 through 2012 those in the highest tax brackets faced at least a 35% marginal tax on their income. That rate just moved up to 39.6%. Keep in mind, this is before any state income tax is added on. Because most muni bonds are tax free (and we are only discussing the tax free version in this report), then an investor in a high tax bracket gets to keep 100% of his interest from municipal bonds instead of giving 39.6 cents of every dollar to the government. To figure out the taxable equivalent yield of a municipal bond — or what you'd have to get in a taxable investment to earn the same return — simply divide the muni bond yield by (1- tax rate). For taxpayer in the highest bracket, it would be the muni bond yield divided by (1-.395), or (.605). For the North Texas Tollway Authority, this would be 5.02/.605, which equals a taxable equivalent yield of 8.3%. On the Bryan, TX Electric bond, the calculation would be 4.00/.605, for a taxable equivalent yield of 6.61%. Keep in mind that these bonds are backed by entities that charge for public services — a toll road and an electric company — and have strong financials. In the case of the North Texas Tollway Authority, there is even an insurance policy guaranteeing the return of principal and interest!

Right now the yield on a 30-year Treasury bond is about 3.5%… and that is before taxes! After tax this bond yields 2.11% for a tax payer in the highest bracket. Yes, this bond is backed by the U.S. government, so there is definitely a premium to be paid for that security. However, comparing a 30-year Treasury at 2.11% yield to the investor with a 21-year municipal bond that yields double (the Bryan, TX bond) or even 150% more (the North Texas Tollway Authority bond) , it is clear to see that muni's are currently trading very cheap!

Another way to compare is by looking at the high quality corporate bond index from the St. Louis Fed. This index currently showed a taxable yield of 4.38% and maturity of 20-30 years. After tax, this index yields 2.644%. There is no doubt that the municipal bonds listed above look pretty good!

The reason they are so cheap is because of fear in the municipal market today.

The Third Part of the Perfect Storm — Fear

There are tens of thousands of municipal bond issuers in the U.S., from school districts to the states themselves. When people hear about a city or water authority going under, they immediately begin to wonder about the other cities and water authorities. This is natural. It's part of self-preservation. It tells us to naturally shy away from a risky situation. The interesting part is that when so many people take this road — simply staying away — it creates a great opportunity for the rest of us. The second strategy outlined above, researching bond issuers, is the way to combat this fear and to find the investment gems that are lying around for anyone who wants to take advantage of them.

Get Them While You Can…

Even as I write this, the prices on municipal bonds are bouncing higher. The scare that the Fed sent through the markets in May and June is wearing off. It's not totally gone — there are still good deals to be had — but the steals are getting harder to find. If you are in the market for bonds and willing to do some good old fashioned leg work, then municipal bonds can definitely fit the bill.

What If Rates Go Up?

Rising interest rates are a real concern. Right now rates are near historic lows because of the Fed, and recent activity shows that when bond markets get nervous rates can shoot higher. But because municipal bonds are already trading so cheaply compared to corporates and Treasuries (as shown above), they afford investors a cushion. This does not mean that municipals won't drop in value. It simply means that the yield an investor receives on a taxable bond would probably have to move up substantially to get near what a similarly rated municipal bond pays today. With that being said, there is no doubt that the best part of a muni bond investment is that you can rest assured that your income is shielded from taxes, which only look to go higher in the years ahead, thereby keeping your hard earned dollars where they belong… in your pocket.

Survive and Prosper Through Every Boom and Bust

One of the keys to surviving and prospering during the years ahead is to grab the most powerful investment opportunities around. Ultimately, you need to create as many income streams as possible.

Obviously that's easier said than done.

You need to be nimble.

You must be ready to sell short or go long an investment at a moment's notice.

You must be able to exit a position at the right time.

You must not let the majority, dumb-money sway you into the wrong positions.

You must have an iron stomach to take the contrarian approach because the research supports it… and not get lulled into taking the easy, mainstream way because… well… because everyone else is.

That's how you take advantage of the booms and busts happening all around us.

We know you have all it takes do enjoy such success… expect for one thing: Time.

You're busy. You don't have the time you really need to identify these booms and busts early enough to jump on board.

You don't have the resources to identify the specific companies that will hand you the returns you're looking for.

You don't have the time to watch the markets like a hawk so you can take the necessary action to protect profits… or triple them.

Honestly, that kind of in-depth research is the job of a team of analysts, who dedicate themselves to digging up all the dirt and diamonds they can so you can invest successfully.

… doing all the dirty work.

Well, that's exactly what we do at Dent Research with our *Boom & Bust* newsletter.

We're constantly scouring demographic trends, economic cycles, predictable consumer spending patterns, technological innovation and acceptance rates, technical indicators, S-Curves and any other tool we can get our hands on or create to uncover the next profitable investment for you… whether it's based on a boom or a bust.

So many factors could trigger a bust or inflate a boom at any moment. Your best chance to protect yourself and grow your wealth is to have up-to-the-minute access to our research and analyses. Not just a daily email that only scratches the surface, but much more.

The research we provide is crucial in the coming months and years. That's why financial advisors, international fund managers and many others depend on my analysis to navigate their companies and clients through unstable markets.

Erin Botsford, a Certified Financial Planner for the Botsford Group told me as much. She said: "*I found Harry Dent in 1995 and built an entire financial planning company around his predictions. The* *recent financial crisis came as no surprise to me or my clients; we were forewarned and therefore, forearmed."*

And Michael Robertson of Robertson and Associates said: "*Harry Dent has been our chief strategist for over 15 years. Without him my clients and I would have gone down the wrong path many years ago. His advice and leadership has added millions to our bottom line."*

That's why YOU need to depend on my research and analysis.

During the next decade and beyond, you too will need continual guidance to help you prepare for what lies ahead, and let me tell you, the picture is bleak…

Unemployment will rise, going as high as 15%. This will negatively impact consumer spending – people will have less to spend – and that decline will affect some industries more than others. That's because there is one generational group in particular that will have the highest levels of unemployment. Do you know who they are?

The real estate market will decline an additional 30%... the "recovery" you're told is underway in this market is no recovery at all. There is only one reason housing prices have risen recently and it's simply not sustainable. Worse still, the generation who should breathe some life back into the market in the years ahead is in no financial position to do anything… let alone buy a home. Mark my words, real estate will roll over and certain sectors of this market are in for an even greater crash, particularly in the next six months.

The euro zone will crumble. Greece is in shambles. More than half of the country's youth are unemployed. Spain is in a double dip recession and will only suffer further. Germany, the supposed saving grace in Europe, is underperforming all expectations. Europe is NOT out of trouble, like Mario Draghi would have you believe. We've identified the one domino most likely to tumble ahead… when it does, it'll set a chain reaction in motion that'll burn around the globe.

The sad fact is that the demographic tide that has brought us to this point, and that will take us the rest of the way down, is unstoppable.

The idiots running the governments and central banks are powerless. They're doing nothing but delaying the inevitable… and making matters worse.

And you should NOT have to suffer because of it.

That's why I recommend you a subscription to *Boom & Bust*. Click here for a 50% discount.

About *Economy & Markets*

In 1989, Harry S. Dent wrote the book *Our Power to Predict*. In it, he revealed how an investor could use demographic trends to accurately predict the direction of the markets, sometimes decades in advance.

Since then, Harry and his business partner Rodney Johnson have been using this New Science of finance to accurately identify booms and busts well ahead of the mainstream.

They gained national attention for their work in warning investors of the 2008 credit crisis and subsequent stock market collapse, many months before it happened.

But this was not the first time they were "on the money" with their big picture forecasts.

For example, in 1989 Harry accurately forecast the Japanese economic collapse and the multi-decade depression in Japan that would follow.

He also called a Dow of 10,000 by the early 2000s at a time when most economists, politicians, businessmen, analysts and investors were expecting the exact opposite. The Dow broke the 10,000 barrier for the first time on April 5, 1999.

In other words, they accurately predicted most of the major economic and stock market events that could have made you substantially richer over the past 20 years.

How do they do it? Well, while most economists focus on short-term trends… policy changes… technical indicators… elections — things that are volatile, unstable and can change from day-to-day — Harry and Rodney focus on long-term trends. Demographics. Business cycles. Human behavior patterns. Things that have demonstrated themselves over hundreds (even thousands) of years to be consistent, predictable and measurable.

They study the past to predict the future… an approach that enables them to forecast years into the future with an incredible degree of accuracy. Then they make minor tweaks and adjustments in response to short-term events that occur along the way.

And that's what they bring to you in *Economy & Markets*, so you'll know what's coming next… where the immediate opportunities are… and where to park your money for the longer term.

As a *Economy & Markets* subscriber, you will know, for example, when it's time to start profiting from the rise of specific emerging market economies (it's not now, despite all the hype about these markets). And exactly what industries and investments will hand you the fastest profits, first.

You'll learn when commodities will likely reach their peak in their cycle and how to ride the gains. You'll also learn when they'll turn down and what investments to make to profit from any moves down.

And you'll learn when the property market will turn up again… you'll learn when, money markets and bonds would be a better investment than stock allocations… and when not.

You'll be ahead of the markets on every boom and bust… access the tools you can use to prepare yourself to survive and prosper.

Meet the Experts

Harry S. Dent Jr.
Editor

Harry studied economics in college in the ’70s, but found it vague and inconclusive. He became so disillusioned by the state of his chosen profession that he turned his back on it. Instead, he threw himself into the burgeoning New Science of Finance where identifying and studying demographic, technological, consumer and many, many other trends empowered him to forecast economic changes.

Since then, he’s spoken to executives, financial advisors and investors around the world. He’s appeared on “Good Morning America,” PBS, CNBC and CNN/FN. He’s been featured in *Barron’s, Investor’s Business Daily, Entrepreneur, Fortune, Success, U.S. News and World Report, Business Week, The Wall Street Journal, American Demographics* and *Omni*. He is a regular guest on Fox Business’s “America’s Nightly Scorecard.”

Harry has written numerous books over the years. In his book *The Great Boom Ahead*, published in 1992, he stood virtually alone in accurately forecasting the unanticipated boom of the 1990s. That same year he authored two consecutive best sellers: *The Roaring 2000s* and *The Roaring 2000s Investor* (Simon and Schuster). In *The Next Great Bubble Boom*, he offered a comprehensive forecast for the following two decades.

In *The Great Depression Ahead*, he outlined how the next great downturn is likely to unfold in three stages, with an interim boom stage between 2012 and 2017 before the long-term slowdown finally turns into the next global boom in the early 2020s.

In *The Great Crash Ahead*, he outlines how this next great crash is likely to unfold in the coming months. He explains why there is nothing the government can do to protect us as deflation takes hold of the economy.

Harry’s latest book, *The Demographic Cliff, How to Survive and Prosper Dueing the Great Deflation of 2014–2019*, shows why we’re facing a “great deflation” after five years of stumilus — and what to do about it now.

Today, he uses the research he developed from years of hands-on business experience to offer readers a positive, easy-to-understand view of the economic future.

Harry got his MBA from Harvard Business School, where he was a Baker Scholar and was elected to the Century Club for leadership excellence.

Rodney Johnson
Editor

Rodney works closely with Harry to study how people spend money as they go through predictable stages of life, how that spending drives our economy and how readers can use this information to invest successfully in any market.

Rodney began his career in financial services on Wall Street in the 1980s with Thomson McKinnon and then Prudential Securities. He started working on projects with Harry in the mid-1990s.

He's a regular guest on several radio programs and is featured on television where he discusses economic trends ranging from the price of oil to the direction of the U.S. economy. He too is a regular guest on Fox Business's "America's Nightly Scorecard." He holds degrees from Georgetown University and Southern Methodist University.

Adam O'Dell
Investment Analyst

Adam has one purpose in mind: to find and bring to subscribers investment opportunities that return maximum profit with the minimum risk. He achieves this with his perfect blend of technical and fundamental analysis.

Tactically, he does exhaustive back-testing and probability-based research. It's the ultimate partner to the exhaustive research that Harry and Rodney do in the exciting realm of the New Science of investing.

Adam has worked as a Prop Trader for a spot Forex firm. While there, he learned the fundamentals of trading in the world's largest market. He excelled at trading the volatile currency markets by seeking out low-risk entry points for trades with high profit potential.

Aiming to find the best opportunities across all asset classes, Adam expanded into the commodities, equities and futures markets.

An MBA graduate and Affiliate Member of the Market Technicians Association, Adam is a lifelong student of the markets.

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