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FOMC remains patient, cautious

Banks boost municipal debt holdings to a record

By Robert B. Segal, CFA, Atlantic Capital Strategies, Inc.

In a statement issued after its April 28 - 29, 2015 meeting, the Federal Open Market Committee acknowledged that economic growth slowed during the first quarter, in part reflecting "transitory" factors. Federal Reserve Chair Janet Yellen and her colleagues hinted that cold weather was partly to blame for the winter slump and repeated their belief that growth will pick up to a "moderate pace."

Policy makers left open the possibility of raising the fed funds rate later in the year by playing down the economy's slowdown in the first quarter. The Fed restated it will raise rates when it sees further labor-market improvement and is "reasonably confident" inflation will rise back to its 2 percent goal over time.

So far this year, most economic releases have been underwhelming. As an example, the Commerce Department said on Wednesday that GDP rose at a 0.2 percent annual pace in the first three months of 2015. This compared with a consensus estimate of a 1.0 percent advance for the quarter and a 2.2 percent gain in the fourth quarter of last year. Economists said part of the poor performance was due to harsh winter weather and delays at West Coast ports caused by a labor dispute.

Fed policy makers are betting on an economic rebound supported by a pick-up in consumer spending. The policy statement noted that "Households' real incomes rose strongly, partly reflecting earlier declines in energy prices, and consumer sentiment remains high."

Consumers have largely saved the "energy dividend" rather than spending the windfall received from lower gas prices. The savings rate climbed to 5.5 percent in the first quarter, the highest since the end of 2012, from 4.6 percent in the fourth quarter. This suggests households could start spending in the second half of the year, which would cause growth to recover.

Speaking at a research conference in San Francisco last month, Chair Yellen said with continued improvement in economic conditions, an increase in the fed funds target rate may well be warranted sometime this year. She said the near-zero setting for the rate has facilitated a sizable reduction in labor market slack, which should eventually produce an increase in inflation. Noting that inflation appears only after a long lag, she argued it will be appropriate to hike rates before reaching the 2 percent target.

According to a recent Bloomberg survey, 73 percent of respondents predicted the central bank will wait until September. In a March poll, a majority predicted the first rate increase in June or July. Futures traders place the first rate hike in the fourth quarter.

Despite the rhetoric over increasing overnight borrowing costs, longer-term rates have declined in the past few months, as the weak economic reports have added to concern about growth momentum. In addition, bond prices have gotten a boost from the European Central Bank's bond-buying program. The ECB started its bond buying in March and the program is scheduled to last through September 2016. Government bond yields in the Eurozone have tumbled, driven by the monetary stimulus. Investors have flocked to Treasuries due to their relative value, pushing down yields in the U.S.

In this environment, banks are boosting municipal-debt holdings to a record even as regulators say the securities aren't sufficiently liquid to make a difference during a credit crisis. Regulators in September issued rules that banks must have enough"easy-to-sell" assets in case of a crisis; municipal bonds were not included in the calculation.

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U.S. financial institutions owned $452 billion of municipals as of Dec. 31, double their ownership at the end of the recession in June 2009, according to the Federal Reserve. These positions now comprise nearly 25 percent of securities holdings. Banks own about 13 percent of municipals, making them the third largest investor group after consumers and mutual funds. Lenders added $33 billion in 2014, which drove a 9.8 percent increase in holdings. Money center banks, in fact, have tripled municipal holdings since 2009.

Citing the increase in bank ownership, the OCC said recently it supports banks making investments in the municipal bond market even as it showed no indication it would be flexible with the new liquidity requirements. "The agency considers bank investments in municipal securities a prudent activity when part of a safe and sound investment strategy," OCC said in a statement.

Banks are buying municipals for their relative value, most agree. Yields on longer-term tax-exempt debt have averaged about 20 basis points above Treasuries for the past few years. As an example, the pre-tax yield on a Double-A rated "bank-qualified" issue is currently about 2.20 percent, compared to 2.00 percent for a 10-Year Treasury, or ratio of 1.10. On a tax-equivalent basis, the 10-Year municipal yield is roughly 3.30 percent. In a rising rate environment, investors typically accept lower yields on municipals than Treasuries because of the tax benefit. Should the Municipal / Treasury yield ratio return to its historical norm of about 0.80 as rates rise, then municipals should experience lower price volatility, reducing interest rate risk. Over the long term, municipals have out-performed all major fixed income asset categories and maintained less volatility than many of their taxable counterparts. For many institutions, it's a compelling argument to include municipals.

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