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## Fixed Income: A Curve For All Seasons

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**For the third year in a row**, market experts are expecting a second-half resurgence in economic activity. Notwithstanding the urge to scream “Not Again!”, this time around the stage is set a little differently, and if all pans out as expected, the fixed income markets should follow a predictable migration to higher yield levels.

Historically, such moves in the Treasury yield curve have been tough to predict, sometimes bending it positively, sometimes negatively and sometimes not at all. Meanwhile, the municipal bond curve has shown an ability to maintain a consistent shape and positive slope — even when the Treasury and corporate yield curves have flattened or inverted.

With interest rates starting to back off the historic 50-year lows posted in mid-June, now is a prime time to explore whether munis are a good alternative for investors looking for better fixed-income investments.

### Upside or Down?

In the last 20 years, Treasury and investment grade corporate yield curves reached an inversion (short-term paper yields higher than long-term) or near-inversion three times. Munis, by contrast, retained a positive curve. Indeed, since 1980, the muni curve has flirted with inversion only once — in March 1989, when the spread differential between the 1-year note and 20-year bond was positive 60 basis points. This anomaly in curve behavior can be attributed to some fundamental differences between the municipal market and its taxable brethren.

More recent curve shifts are more illustrative of munis' resilience. In 1993 and 1994, for instance, the Treasury curve showed typical characteristics of a bullish economy by flattening considerably. The Fed responded to the threat of inflation by raising rates six times that year, from 3 percent to 5.5 percent. The municipal bond yield curve, due to its relative value on a tax-exempt basis, tracked Treasuries as yields changed, but it did not flatten. Indeed, because municipals are not tools of monetary policy, curve behavior and variation will always be derived from (not created by) relative value to the available taxable alternatives.

Muni stability is also explained by their ownership: Individual investors looking for buy-and-hold investments control roughly 75 percent of the municipal marketplace. Further, while the institutions that dominate the Treasury market trade well over an estimated \$350 billion in dollar volume per day, municipals trade just around \$10 billion. These fundamental differences lead to a more predictable, less volatile municipal marketplace.

So what does this mean in the current market? A migration to higher yield levels is in the offing, meaning that tactical traders are likely to be compelled to hunt for the most optimal point — the highest yield — on the curve to invest. As the economy continues to expand and capital becomes scarce, the Treasury and corporate buyers will tend to liquidate longer maturity bonds and move shorter on the curve to achieve the highest current yield available. But this is not the case in the municipal market. True to its nature, it maintains a positively sloped yield curve.

## The Cash Effect

True, as money becomes scarce, the municipal yield curve will change, but not to the extent where investors will need to move down the curve (shorter in maturity) to increase current income. The buy-and-hold municipal investors will still be paid more “rent” on their money as they move out in maturity.

For the average municipal bond investor, this unique anomaly in the municipal marketplace allows some cushion from the drastic yield curve shifts that occur in the taxable markets.

Clearly, reductions in maturity and duration risk measures during — or just prior to — interest rate rises are preferred strategies for most fixed-income investors. However, any investor contemplating a reallocation to cash must first perform an analysis of breakeven spreads that details time periods and interest rate changes.

History shows that for municipal security investors, being too short in maturity can be costly indeed.

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