OCTOBER’S CONSISTENCY WITH HISTORY
October’s municipal price patterns followed historical form. At the end of September, municipal offering levels were near 2006 historical extremes, the Consensus Price Index threatened to breakdown through its 13-week positive trend line and the seasonal patterns of 2001-2005 (Figure 1) suggested a degree of immediate risk. And indeed between September 30 and October 24, municipal cash offering levels returned to a relative condition of value providing opportunity for investors. The Consensus Price Index held a negative bias from October 4 to 25, after which it regained its positive trend. This 3 week decline followed patterns defined by the last 5 years of trading as did the rebound in the last week of trading.

UNPRECEDENTED RALLY
The month-end 5-day rally was the strongest price advance and yield decline since August 2004. The first evidence of a stronger market condition was in the BMA swap market where yields continually outperformed the cash levels as defined by the Consensus median. The aggressive pricing of new issues in the wake of the unchanged rate decision by the FOMC allowed investors to aggressively pursue longer maturities. Belief in an ultimately steeper curve (created by an eventual decline of short-term rates) appeared to encourage the re-entry of leveraged programs to the market, movement of investors from cash equivalents to bonds and other duration extension trades with a fervor similar to January and February.

BMA/LIBOR RATIOS A DRIVING MARKET FORCE
During the rally, there was particular attention paid to the rapid decline of the BMA/Libor swap ratio that has become an increasingly attractive vehicle for large speculative transactions in the derivative market. The influential effect of primary bond pricing on the BMA swap rates relative to Libor can result in beneficial ratio movements for transactions of larger size than possible in the cash market. The growing movement of traditional investors finding more comfort in valuing cash bonds relative to the BMA swap curve can therefore result in spread imbalance that create an appearance of value in the cash market. This was the case in late October with a rallying BMA curve creating “attractive” conditions in the cash market for traditional investors eager to enter a rallying market environment. Between October 24 and 30, the 10 and 30-year swap ratios declined 2%, a large amount when placed in the context that speculative transactions occur with regularity for a 1/4 percent (i.e. ratio).

TOTAL RATE OF RETURN (TRR)
The Consensus cash curve, 2 to 30-year, flattened to a slope less than 90 basis points. In May and June 1989, the municipal curve flattened to 60 basis points. During the same period, the Treasury 2 to 30-year slope inverted by as much as 38 basis points and had an average slope for the 5-week period of -21 basis points. At the end of October 2006, the Treasury curve was positively sloped by 3 basis points. The municipal market’s flattening curve again rewarded investors in the longer maturities. The Consensus TRR Indices, reflected gains in excess of 1% in the maturities of 15-years and longer. The longest maturities of the curve, have had a 7% return YTD.

ISSUANCE/DEMAND
October’s primary issuance was $29.94B (below $30B for the 2nd consecutive year). The YTD issuance was $295B. Over the past 5 years, the average issuance for the last two months of the year has been $60B while reinvestment for 2006’s last two months has been estimated at $40B. While the issuance/reinvestment imbalance, historically, would suggest a negative risk condition, the movement of cash extensions out the yield curve, revitalized speculative transactions based on the prospects of higher taxes and renewed leveraged and foreign activity has stimulated new demand for municipal exposure.

Figure 1: Since 2001 November’s has a history of risk.

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