MONTHLY REVIEW

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MAINLINE WEST

Markups Are Getting Marked Down

No, Kmart is not making a comeback, but lower profitability in public finance is. In our January monthly review "Going, Going Citi Gone", MainLine reviewed the evolving nature of muni underwriting and broker/dealer participants. There has been a change in the big players and in the flow of muni bonds over the years. This month, with the help of a study from the University of Georgia that reviews the trend in underwriting markups and big bank profitability, MainLine will turn the blue light on as to why some think Citi is gone.

The month of October was a tough month for fixed income assets and munis were not immune to this. The muni market feasted on a smorgasbord of new issuance – the second highest month on record. After digesting over $56 billion and almost 40 bps higher in yields, munis look to be going into hibernation until the end of 2024. One thing is for sure, there has not been a lack of muni cuisine to feast on for investors with cash. MainLine feels October could be the month that sets up a November to be determined.

Muni Market Review

The muni market all you can eat buffet of new issuance has finally come to an end and, just like most people, it ended the month with an upset stomach and as an outperformer. The Bloomberg Munis composite index was down -1.47%, US Treasury index was down 2.38% and US corporates were the biggest underperformers down 2.43%. As the month was coming to an end, munis were comatose and waiting for the election. October highlights were as follows:

- Munis yields were higher from 37 to 35 bps with the ten and fifteen years underperforming the most. Taxable yields were higher 54 to 34 bps.
- Supply for the month was the second largest month on record as issuers pulled deals forward, ahead of the election. Year-to-date issuance is up 37% and higher by 19% versus the five-year average. MainLine expects issuance to be way down for the next couple of weeks and finish at a manageable pace through year-end.
- Muni demand remains stable and slowly growing with 12 weeks positive (twenty-one out of twenty-four weeks) and levels that are double those of mid-summer.

- The muni fear index is up due to the election. At the time of this writing, yield volatility is up from 6% thirty days ago to 24%, and the VIX was 17% is now at 23%. This counters the technical plus of lower issuance and growing demand going forward.

MainLine feels munis are set up after a rough stretch to bounce back and finish 2024 strong. How strong? That depends a variety of factors we expect to encounter in the weeks ahead.

Market News & Credit Update:

- New issue supply for infrastructure is now close to $300 billion, highest since 2013, and up 20% versus 2023. Why such a big increase? Federal stimulus funds are no longer available for funding projects from COVID, costs of construction are higher and requiring more money being borrowed, and the increase in need for projects from years of neglect.
- Hurricane Helena & Milton have brought back into focus catastrophe bonds, also called "Cat bonds" and their use in muni finance, as they are a tax-free bond sector. An initial concern of these bonds being worth 67 cents on the dollar as Milton approached, is now nothing more than a reminder of this sector and it price volatility. Cat bonds are issued by Florida to provide home insurance to residents that private insurers will not insure. These bonds are backed by the insurance premiums charged for the policies. Not your sleep well at night sector, but one that provides a "public good", but is an uncomfortable bet on the probability of a huge natural disaster. MainLine will take a closer look at this unconventional muni sector in next month's market review.

Markups are Getting Marked Down

Introduction:

In our January monthly review "Going, Going Citi Gone", MainLine reviewed the evolving nature of muni underwriting and broker/dealer participants. There has been a change in the big players and in the flow of muni bonds over the years. MainLine highlighted the exit of Citibank, the cutting back of underwriting practices by UBS, and the decrease in sales departments, banking, and other public finance personnel.

MainLine will put some more meat on these bones in this month's review by reviewing a comprehensive study by the University of Georgia, authored by John Hund and his associates. It focuses on the changes in the municipal market's underwriting practices, impact on profitability and proposed costs of these changes to issuers.

Background:

The analysis is very comprehensive using data on trades and underwriting spreads from 2005 to 2023. The study focused on the ability to markup offerings, and its downward trend over the years. Over 12.3 million trades were reviewed from 183,000 new issue deals and over 2 million bonds. Both, large nationally and small single state underwritten deals were included in the study.

To calculate underwriting profits the study tracks the pricing of a deal and then the sale of the bonds in the secondary market, and their price difference (called markup). Time for secondary transactions were limited to 14 days or less from the initial underwriting day.

Bonds bought at the primary offering are not included in the mark-up study, as they are purchased at the initial underwriting cost. MainLine buys most of its clients' bonds at this unmarked-up price. The markup occurs when these bonds are reoffered and sold at a higher price to buyers not involved in the initial offering.

Analysis Results:

The result of the study shows over the years that the average markup has gone down from 152 bps, to 96 bps. This is roughly a 50% drop in underwriting profits. This drop in mark-up has led to lower profitability, and, according to the study, the reason for the exit of Citibank and UBS from muni underwriting. Also as we discussed, this could also be why other firms have cut back on their commitment to public finance.

The paper defines the ability to markup price is due to "uninformed" investors. This study goes on to say that muni investors now have become more informed, due to the increase in price transparency (MSRB reporting), and an increase in the use of professional money managers, such as SMA's, and Funds. This has created fewer direct retail "uninformed investors" giving the underwriters the ability to markup bonds excessively, as was done in the past. It also cites the increased use of technology as another reason for more price transparency.

It concludes that the decline in markups is good for investors, but the decrease in profitability and the continued loss of big banks participation could lead to higher issuance costs for municipalities. This could be long-term negative for investors, due to the increased cost causing higher yields to borrow money for issuers. This higher cost could offset the lower markups and savings for investors. This was only a question posed by the study and will be reviewed in a future one. This study did look at Texas bonds and the impact on yields once Citibank was banned from underwriting deals in 2023. Over this short time frame, there has been no real increase in issuance costs realized by Texas issuers.

Conclusions:

MainLine agrees with the approach and the initial findings of this analysis but there are a few things we would like to have seen explored further.

- Is the drop in bps of markups from 152 to 96 a byproduct of a lower interest rate environment? This analysis was done during a predominant period of declining interest rates from 2005 to 2021 with a few spike ups along the way. Only in the last two years have rates gone up. The 152 bps as a percent of the average muni yield in 2005-2006 was roughly 35%. In 2023 the 96 bps would have been roughly 27% of the average muni tax-exempt yield. The markup. If unchanged as a percent of income in 2023, (35%) would have been 129 bps. This is close to half the amount, all due to lower yields. Lastly, if the 152 bps was still the mark up in the lower rate environment it would roughly been cutting the income level a little less than in half. Seems a bit excessive markup even for "uninformed "investors.
- The study discussed technology as another reason for lower mark-ups. MainLine would take this a step further and add in algorithm trading (see or May 2024 monthly review for more details). As bonds get offered trading models being used will set prices to buy and to sell within a range to make money. This can limit the amount of the markup or markdown as it will buy or sell those bonds that fall outside a "decent" profit. Algos are protecting the uniformed but at a cost, just not as big as the big banks use to take advantage of the uninformed.
- Final consideration, UBS still underwrites competitively, they simply stopped participation in negotiated deals. One would think that competitive underwriting would also have lower markups. So why is UBS still pursuing competitive underwriting? This is not discussed in the analysis and is inconsistent with the study's results.

MainLine finds the study very comprehensive and structurally sound. It also does a good job explaining why firms may be cutting back on their commitment to muni finance. There is better pricing disclosure, better evaluation models, and a bigger presence of "informed" muni investors. How it plays out in the coming years will show how much of this change is structural, rate driven and if the profit margins of muni finance are truly under strain and at risk of losing large bank liquidity and distribution. Either way, the flow chart of municipal bonds has been changing, and a buyer's approach to finding the right bond at the right price will remain important in looking to maximize tax-exempt income, going forward.