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THE BOND BUYER

Stocks, Treasuries -- For Yield, Muni's Beat Them All

By Sonja Ryst | 05-26-1999

Municipal bonds offer better value right now than both Treasuries and the stock market, according to one portfolio fund manager.

As municipal yields topped 100% of the Treasury long bond last fall, investors took note of the favorable trading relationship. But B. Clark Stamper, president and portfolio manager with Stamper Capital & Investments, Inc., says that munis are also cheap to equities.

"While an investor is hanging out waiting for [market] relationships to normalize, if they are invested in municipal bonds, they are getting the highest relative yields while they wait," said Stamper, who runs the Davis Tax-Free High Income Fund in Monterey, Calif.

As market players grow wary of potential rising interest rates, spurred by the Federal Open Market Committee's tightening bias, Treasury prices have slid downward. On the other hand, spreads between government yields and the inflation rate are at 400 basis points, much wider than the usual 200.

With Treasuries' yields historically low, Stamper said munis are "as attractive as they get."

By comparing the yield of The Bond Buyer 40-bond index to Treasury yields, Stamper found a ratio showing that munis are close to their cheapest since before the bond market drop in early 1987. Municipals have become even more low-budget than they were in 1994, when buyers panicked on talk of a flat tax.

If munis are a relative bargain compared to Treasuries, they're a steal compared to stocks, according to Stamper. Comparing Standard & Poor's 500 index to government yields shows that Treasuries are cheaper than stocks -- even more so now than they were in August 1987, he said.

Dividing The Bond Buyer 40 yield by the dividend yield of the S&P 500 shows a similar relationship for munis, which offer more value relative to stocks and Treasuries than they did right before the previous decade's market crash.

The dividend yield on stocks is at an all-time low, Stamper said. Investors are getting almost four times as much yield from bonds as they would from equities.

"I think that some of the overreaction by the debt markets in recent weeks is a substantial buying opportunity," agreed Jeff Hollingsworth, an analyst at A.G. Edwards & Sons Inc. "While offering high relative value, municipal bonds demonstrate far less volatility."

But Hollingsworth pointed out that the attractive relationship is starting to retreat. Municipals' stable price performance compared to Treasuries has not been the result of the stock market being overvalued, but because supply in 1998 was so heavy. Now that all the refundings are out of the way, valuations have started going down a bit.

George Friedlander, managing director and fixed income strategist at Salomon Smith Barney Inc., said that munis are only "moderately cheap." After having been as high as 106% of Treasuries, they are now at only about 90%.

Munis are at that level because prices have exploded on the stock market, making stock yields dwindle, Friedlander said. "That has nothing to do with munis having moved in relation to stocks," he said. "Most investors don't buy stocks for yield anymore. The last thing we talk about when making a recommendation is the dividend deals."

Stamper expects municipal bonds to outperform soon, predicting the equity market will continue to get hammered on its way to a correction and cause money to flow out of stock funds and into muni funds.

"That money will reverse both of these trends" that make munis cheap, Stamper predicted.

Hollingsworth said retail investors have already started "seeking refuge in the bond markets." The analyst does not think that a good performance in munis necessarily has to preclude stock market growth. In an environment where inflation is well- contained and bonds perform well, stocks can also flourish, he said.

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