

The Future of the Ratio of Municipal Yields to Taxable Yields

The future of municipal yields will be discussed in four parts: 1) The outlook for the ratio of prime long municipal yields to similar taxable bond yields; 2) The outlook for prime long taxable bond yields; 3) The outlook for the municipal risk factor; and 4) The outlook for the municipal yield curve according to maturity.

Since 80-90% of all new credit instruments are taxable (see Table IV), it is the taxable yields which dominate the trends of the bond market as a whole. Municipal yields adjust to taxable yields. The size of the adjustment depends partly on the volume of new municipal financing, partly on tax rates, but most importantly on the volume and direction of savings flows—whether they flow to higher bracket investors or to lower bracket investors, and by how much.

It seems reasonable to believe that in the decade ahead the volume of new municipal financing will continue to grow, but it will not grow as fast as the economy as a whole or as the total of capital market expansion. This lag is assumed partly because it has been noticeable for several years and partly because municipal financing will continue to be high cost financing and, therefore, politically unpopular. There will continue to be efforts to find easier ways to finance desirable projects.

Furthermore, the tables seem to show clearly that if by chance there is a rapid increase in the volume of municipal credit demands (for example, from an increase in industrial issues), the funds of the investor groups who are now buying would soon be inadequate. If so, municipals would have to be repriced—maybe up to 90% of corporate yields. This means 4.50% for prime municipals if corporates are 5%, and probably 5.40% for second grades if second grade corporates are 6%. These higher yields would be necessary to attract large funds from lower bracket life insurance companies and savings insti-