Bond Case Briefs

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A Trump-Era Strategy for Municipal Bonds.

The Trump administration's plans to radically overhaul the tax code could weigh on munis—but it could create buying opportunities.

Municipal-bond investors have a lot of reasons to wring their hands in 2017. The Federal Reserve seems intent on hiking rates as many as three times this year, and President Donald Trump is threatening to radically rewrite tax policy, potentially even limiting the tax-exempt status of munis.

Even so, munis have a lot going for them. They provide a low-risk way to diversify when the biggest risk to your portfolio might be from overpriced stocks. Most munis are high-quality, and the asset class has historically had a negative correlation to equities, according to Standard & Poor's.

Even better, munis are a lot cheaper than they were a year ago, which means they yield more. (Bond yields move inversely to prices.) After a fourth quarter of rising interest rates, the average yield on a 10-year triple-A-rated muni bond rose to 2.4%, equivalent to a 4% taxable yield for individuals in a high tax bracket. That compares to 1.9% a year ago, says James Grabovac, investment strategist at McDonnell Investment Management.

Another sign of value, he notes: The 10-year muni-bond yield is nearly the same as the 10-year Treasury yield, up from just 85% a year ago.

"The psychology of the market is much improved" since late last year, says John Miller, co-head of fixed income at Nuveen Asset Management. "Prices haven't moved that much, but they are stable with a slight upward bias." Plus, inflows have been positive for the past five weeks after 10 weeks of sharp postelection outflows.

Though changes to the individual tax code appear to be on the back burner, as the Trump administration attempts to deal with corporate tax reform first, there are two main concerns.

The first—reducing or eliminating munis' tax-exempt status—will likely be floated, but is unlikely to succeed. "It has come up before, and it always dies," says James Kochan, chief fixed-income strategist at Wells Fargo Funds. "Sometimes a fairly quick death." Infrastructure spending, a goal of this administration, is usually funded by states and cities issuing munis, so it seems unlikely Trump would want to disrupt the market, notes Grabovac.

Cutting marginal tax rates could also make munis less attractive, though it has happened before and the asset class held up just fine. BlackRock looked at what would happen if there was a cut in the highest tax rate to 33%, and found it would lead to just a 0.15 to 0.5 percentage-point rise in yields, depending on maturity. That's not such a big penalty.

SUCH TAX PROPOSALS could stoke volatility, which would create buying opportunities for nimble investors prepared to take advantage of a selloff. Sean Carney, who heads municipal strategy at BlackRock, says more investors are already using muni exchange-traded funds, such as his firm's iShares National Muni Bond (ticker: MUB), to buy on weakness and sell on strength. He thinks the approach makes sense now.

Closed-end funds, many of which have been volatile as they have reduced their payouts, are another option. Eaton Vance Municipal Income (EVN), for one, is already selling at a discount, when it usually commands a premium. It yields 5.53%.

Volatility may also come from a surge in new muni-bond supply in March, a typical seasonal pattern, or more credit downgrades in states grappling with budget shortfalls and pension-related costs.

An actively managed fund makes sense for investors who prefer not to trade. The top-performing fund in the past year, up 3.3%, is Nuveen Inflation Protected Municipal Bond (NITAX), which hedges against interest-rate risk. Nuveen All-American Municipal Bond (FLAAX)—the firm's traditional muni offering—has a 4.9% average annual return for the past 10 years, putting it in the top 2% of all national long-term muni funds.

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