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Muni Debt That Beat Stocks Likely Won't Deliver Repeat Next Year.

- **Tobacco sector may return 5 percent in 2018, Barclays says**
- **Cigarette tax and smoking age increases will weigh on prices**

High-yield municipal bonds backed by legal-settlement payments from tobacco companies have returned 20.4 percent this year, more than the S&P 500 index. Don't expect a repeat in 2018.

Investors in the sector may have to settle for the income they get from interest payments — instead of price gains — as higher tobacco taxes in California and the U.S. Food and Drug Administration's plans to cut the nicotine in cigarettes to non-addictive levels threaten to weigh on the industry's sales. The payments that back tobacco bonds are based on cigarette shipments, which are affected by the overall economy, government regulation and excise taxes.

"They don't have a lot of upside left in them," said Guy Davidson, director of municipal fixed income for AllianceBernstein LP.

Junk-rated tobacco bonds have beaten the S&P 500 index three of the last five years, though almost all of the sector's gains this year came in the first half. The securities rebounded after money managers dumped the securities — among the most liquid high-yield municipal bonds — to meet redemptions during the bond-market rout that erupted after President Donald Trump's victory.

Refinancings by New York City and California that reduced the amount of debt and lower-tha--forecast smoking declines have also boosted prices.

Since the FDA announced its plan to lower nicotine levels in cigarettes in late July, the sector has returned 1.6 percent, lagging the 2.1 percent gain for the the broader high-yield muni market over the period. Junk-rated tobacco bonds make up about 20 percent of the Bloomberg Barclays Municipal High Yield Index.

The largest single tobacco bond, issued by an Ohio agency and maturing in 2047, trades at about 96 cents on the dollar, or a cent less than the 2007 issue price, and is up more than 50 percent since Sept. 2013. Many tobacco bonds can be bought back at par from investors before maturity, which may limit further upside because the securities are already trading close to 100 cents on the dollar, Davidson said.

Even though the FDA proposal may take more than a year to enact, performance next year will be hindered by other factors, Mikhail Foux, the head of municipal strategy for Barclays Plc, said in an interview. Tobacco sales may be curbed by a $2 per-pack tax increase in California that took affect April 1 and a raising of the minimum smoking age to 21 in that state as well as New Jersey and Oregon, Foux said.

The production of cigarettes has declined 2.5 percent through September 2017 compared with the same period last year, according to data from the Alcohol and Tobacco Tax and Trade Bureau.

An improving U.S. economy may blunt the impact of cigarette tax and smoking age increases, said Foux, who predicted tobacco bonds may return about 5 percent in 2018.

AllianceBernstein reduced tobacco-bond holdings in its muni high yield fund to 4.3 percent from 7 percent in June.

“The best scenario for the 2007-vintage tobacco bonds is a stable market where investors earn the yield on their bonds,” Davidson said.

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