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Muni Bonds: Recession Potential Warrants Second Look

Recessionary pressures on the economy continue to mount, as the Fed tries to toe the line between raising interest rates to combat inflation and maintaining economic growth. In the meantime, muni bonds present investors with a prime fixed income option.

Given rising rates, fixed income investors have yield top of mind. At the same time, they also need quality exposure, given the threat of recession. Both can be addressed via muni bonds.

“Should the U.S. economy fall into a recession, high yield municipals may fare better than their taxable counterparts,” private asset manager Lord Abbett noted. “Over the long term, municipal bonds historically have experienced a fraction of the default rates of similarly rated corporate bonds.”

The aforementioned blog post, in particular, looked at periods of recession and how muni bonds fared.

“Focusing specifically on recessionary periods, municipal fundamentals have historically outperformed corporates: during the past five economic contractions in the United States, municipal bonds’ credit ratings have been much more stable, and default rates have been much lower relative to corporate bonds,” the asset manager added.

2 Cost-Effective Muni Bonds ETFs

Not sure where to start with getting municipal bond exposure? One fund to consider, especially for the cost-conscious investor, is the Vanguard Tax-Exempt Bond ETF (VTEB).

With a 0.05% expense ratio, the fund offers low-cost exposure to municipal debt. Comparable funds have an average expense ratio of 0.68%, based on Morningstar data.

VTEB tracks the Standard & Poor’s National AMT-Free Municipal Bond Index, which measures the performance of the investment-grade segment of the U.S. municipal bond market. This index includes muni bonds from primarily state or local governments, or agencies exempt from U.S. federal income taxes and the federal alternative minimum tax (AMT).

Another option launched just months ago is the Vanguard Short-Term Tax-Exempt Bond ETF (VTES). The fund, with its similarly low 0.06% expense ratio, seeks to track the S&P 0–7 Year National AMT-Free Municipal Bond Index, which is designed to meld two benefits of municipal bond exposure: tax efficiency and tax-exempt yield.

VTES’ benchmark includes bonds with maturities ranging from 0–1 years as well as 5–7 years. As such, investors get the risk-mitigating benefits of short-term exposure while also obtaining more yield, common with longer-duration bonds.

Given this balance, VTES may best suit investors with an investment horizon of two to four years. Additionally, it could work for high net worth clients looking for tax-exempt income.

“VTES is designed for tax-sensitive investors who have a preference for taking on less interest rate risk than the overall municipal market,” said Jeff Johnson, head of fixed income product at Vanguard, in an interview with VettaFi.

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MAY 19, 2023

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