Bond Case Briefs

Municipal Finance Law Since 1971

Muni Bond Fund Rebound Appears to Have Legs.

After an abysmal year in 2013, municipal bonds are back — and may offer positive returns for some time to come.

Through March 11, the S&P municipal bond index is up 3.01%, a sharp departure from last year, when the index lost 2.55%, making 2013 only the fourth year of negative returns in the past 25, according to Jim Grabovac, senior portfolio manager at McDonnell Investment Management.

In response to the performance turnaround, investors are warming up to the asset class. After 10 straight months of net outflows in municipal bond funds totaling more $57 billion in 2013, more than $2 billion in net inflows poured back into the funds through Feb. 28, according to data from Morningstar Inc.

Muni funds' performance revival has been spurred by falling interest rates throughout the fixed-income market, along with higher taxes and subsiding fears over Detroit's and Puerto Rico's dicey finances, analysts say. Meanwhile, the biggest threat — looming rate hikes in the aftermath of the Federal Reserve's tapering — isn't expected to weigh too heavily on prices in the near future.

At the heart of much of 2013's weak performance was the Federal Reserve. Rumors that the central bank would begin tapering in September caused jitters throughout the fixed-income market, putting downward pressure on municipal bond prices, said Steven Pikelny, an analyst at Morningstar Inc.

The decline was further exacerbated by Detroit's bankruptcy, as well as diminishing investor confidence in Puerto Rico. In October, yields on the island's bonds jumped to as high as 10%. This accelerated outflows and put a big dent in the municipal funds market, Mr. Pikelny said.

"The Puerto Rican municipal bond index fell about 20% for the year," Mr. Pikelny said. "Since the island makes up a pretty big chunk of the muni universe, a drop like that could mean a 1% loss for a municipal bond fund."

This year's turnaround has been aided by the broader fixed-income market, Mr. Grabovac said.

"If you look at the broader picture, there was volatility in emerging markets that triggered a flight to quality, including muni bonds," Mr. Grabovac said. "The bad weather throughout much of the country [and resultant weak jobs reports] also dampened fears of a faster Fed taper," he said.

In addition, municipal bonds, which are exempt from income tax, received a boost from 2013's tax hikes, including the increase in the top marginal income tax rate and the 3.8% net investment income tax, Mr. Grabovac said.

"This was overwhelmed in 2013 by sentiment from tapering fears," Mr. Grabovac said. "Now that we are approaching tax season, there seems to be a heightened interest in after-tax income."

The final source of falling yields may be less sustainable: municipals have been in tight supply. The supply crunch started in 2013 as high rates dissuaded many municipalities from refinancing debt, Mr. Grabovac explained.

But now supply is normalizing, Mr. Colby said. Puerto Rico just sold $3.5 billion worth of bonds, California just sold about $1.6 billion, and Chicago just struck a deal for roughly $700 million. The question is whether demand is healthy enough to absorb these additional sales without a drop in price, he said.

In the long term, the biggest influence on municipal bond prices remains the Federal Reserve. With a lot of slack left in the labor market, and the Fed still pumping out billions of dollars of liquidity each month, few analysts expect a spike in interest rates anytime soon. Meanwhile, there are plenty of reasons for organic demand to keep municipal bond prices afloat.

"If you look at the objective of a portfolio, municipals offer good after tax income with potentially no correlation to the equity market," Mr. Grabovac said. "That makes them a pretty good diversifier."

By Carl O'Donnell

Mar 13, 2014 @ 12:01 am (Updated 3:25 pm) EST