

Bond Case Briefs

Municipal Finance Law Since 1971

Record Run Trouncing Treasuries Shows Tax-Free Lure: Muni Credit.

Even when the municipal-bond market loses, it's proving a winner.

Tax-free state and local debt has declined 0.5 percent in June, on pace for the first monthly decline of 2014, Bank of America Merrill Lynch data show. That still leaves the \$3.7 trillion market in better shape than Treasuries, which have lost 0.7 percent. Munis are on pace to outperform their federal counterparts in total return for an unprecedented 10th straight month. They're also beating investment-grade company debt.

Tax-exempt borrowings are luring individuals who in April faced levies on bond interest payments as much as 24 percent higher than in 2012. At one point this month, buyers were willing to purchase munis at the lowest yields relative to Treasuries in three years, data compiled by Bloomberg show.

"We just got a kick up in tax rates, and that will bring more people into the market and help it clear at lower ratios," said Phil Fischer, head of muni research at Bank of America in New York. "There's a tremendous amount of demand for munis."

Investors in munis compare yields on state and local securities to those on Treasuries to assess relative value. The ratio for 10-year bonds fell to 86 percent on June 4, the smallest since June 2011, Bloomberg data show. The lower the figure, the costlier munis are relative to Treasuries.

Revealing Ratio

The ratio has averaged 94 percent since 2001, though during the past three years it has typically been about 104 percent. Investors tend to accept lower yields on munis versus Treasuries because of the tax exemption on local debt.

The strongest start to a year since 2009 for munis has pushed the ratio lower. Since Bank of America data on tax-exempt debt begin in 1989, state and local bonds have never outperformed Treasuries for 10 straight months. The previous record of nine lasted from June 2004 to February 2005.

Munis are outpacing this month's 0.6 percent loss on investment-grade corporate bonds, while trailing the 0.6 percent gain for high-yield company securities.

More than half of the municipal market is owned by individuals, who usually buy the debt for tax-free income rather than total returns. The bonds are generally exempt from federal, state and local taxes for residents in most states where they're issued.

'Key Driver'

Individual investors have added money to muni mutual funds in 18 of 23 weeks this year after a record wave of withdrawals in 2013, when the fixed-income market sold off broadly, Lipper US Fund Flows data show. The revived demand, combined with the fewest new muni sales since 2011, pushed

benchmark 10-year yields to a one-year low this month.

“The tax increases have been a key driver on the demand we’ve seen,” said Kevin Ramundo, who helps oversee \$28 billion of state and local debt at Fidelity Investments in Merrimack, New Hampshire. “Barring any type of non-muni event, I can see munis continuing to perform quite well.”

This year, high earners faced bills that for the first time include federal tax increases that took effect last year: a top marginal rate of 39.6 percent, up from 35 percent; and a 20 percent tax on long-term capital gains and dividends, up from 15 percent. The top tax bracket is the highest since 2000.

The increases coincide with a 3.8 percent tax on investment income applied to top earners last year as a result of the 2010 Patient Protection and Affordable Care Act.

43.4% Tax

With a top federal tax rate of 43.4 percent when including the new tax on investment income, the 2.4 percent yield on benchmark 10-year munis is equivalent to a taxable interest rate of 4.24 percent.

By comparison, Treasuries maturing in 10 years yield about 2.6 percent. Stated another way, when adjusted to a comparable taxable rate for the highest earners, AAA muni yields are about 160 percent of those on their federal counterparts.

The municipal market “isn’t as cheap as it was,” said Jamie Iselin, head of munis at New York-based Neuberger Berman, which oversees about \$9 billion in local debt. “But I also wouldn’t say — especially when you tax-adjust it — that it’s rich either.”

By Brian Chappatta Jun 18, 2014 5:00 PM PT

To contact the reporter on this story: Brian Chappatta in New York at bchappatta1@bloomberg.net

To contact the editors responsible for this story: Stephen Merelman at smerelman@bloomberg.net
Mark Tannenbaum, Mark Schoifet