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Elections Season Could Shake Up Muni ETFs.

The municipal bond market, along with related exchange traded funds, have been steadily strengthening as austerity across local governments keeps supply low, but midterm elections could affect the munis market ahead.

For instance, in Illinois, the state income tax is a key factor to watch, according to Peter Hayes, Managing Director, head of BlackRock's Municipal Bonds Group.

Specifically, the temporary tax increase to 5% is set to expire at year-end and will move back down to 3.75%. The Democratic incumbent governor wants to extend the tax increase while the Republican challenger is fine with letting it expire. If the Democrats have their way, the higher state tax rate would entice more Illinois investors to hold onto munis and benefit from the state tax exemption on Illinois-issued debt.

Additionally, in Pennsylvania, "pension reform will be a critical point on how the state is viewed by credit ratings agencies and broader municipal market," Hayes added.

Muni ETF investors have a number of options to gain exposure to these state bonds. For example, the iShares National AMT-Free Muni Bond ETF (NYSEArca: MUB) includes a 5.3% tilt toward Illinois and 3.0% in Pennsylvania. The Market Vectors Intermediate Municipal Index ETF (NYSEArca: ITM) allocates Illinois 4.0% and Pennsylvania 2.2%. Additionally, the PIMCO Intermediate Municipal Bond ETF (NYSEArca: MUNI) holds 6.1% in Illinois-issued debt and 4.9% in Pennsylvania debt.

MUB has a 6.41 year duration and a 1.58% 30-day SEC yield or a 2.79% taxable equivalent yield for those in the highest income bracket. ITM has a 7.17 year duration and a 2.46% 30-day SEC yield or a 3.39% taxable equivalent yield. MUNI has a 4.65 year duration and a 1.15% 30-day SEC yield.

Moreover, there are just a few bond initiatives for this election season. For example, California's Proposition 2, or the so-called Rainy Day Budget Stabilization Act, will help provide a greater cushion for the state government in case of another financial crisis or emergency.

The proposition "has the potential to significantly improve the state's financial flexibility and credit rating going forward," Hayes said.

California accounts for a large portion of the broad muni bond ETFs, including 22.7% in MUB, 15.1% in ITM and 11.7% in MUNI. Alternatively, investors can specifically target California muni bonds through the iShares California AMT-Free Muni Bond ETF (NYSEArca: CMF), SPDR Nuveen Barclays California Municipal Bond ETF (NYSEArca: CXA) and PowerShares Insured California Municipal Bond Portfolio (NYSEArca: PWZ).

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