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Muni Bonds: Calm Ahead for 2015?

At times over the past few years, municipal bonds seemed to stray from their traditional role as staid income generators and morph into momentum investments, with performance driven by herds of investors alternately piling into munis or abandoning them, based on a variety of largely external forces.

Heading into 2015, the market hopes that fundamentals will re-emerge as the main performance drivers. For that to happen, munis must stare down two key risks: that rising rates cause greater volatility, and that Congress meddles with muni bonds' longstanding tax-exempt status.

THE MUNI MARKET SAILED through 2014, posting an 8.9% return, per S&P Dow Jones Indices, aided by the tail wind of an unexpected decline in interest rates. Longer-dated munis led the way, gaining 15.5%, while a popular exchange-traded fund, iShares National AMT-Free Muni Bond (ticker: MUB), gained 6.2%. That strong showing marked a rebound from an awful 2013, in which munis lost 2.6% and the same ETF fell by 3.3% after rates rose.

In its latest fixed-income strategy report, U.S. Trust attributes much of the market's 2014 performance to technical factors, namely robust demand and an unusually low supply of new bonds. Many bonds issued in recent years were simply used to refinance older higher-rate debt, while the overall supply of muni bonds shrank as maturing debt exceeded new supply.

U.S. Trust says that more new bonds are now being issued, and that supply "will continue to pick up as improving fiscal conditions at the state and local government levels allow for greater issuance of municipal bonds to satisfy pent-up infrastructure needs." U.S. Trust adds that muni-bond demand could fall this year for a few reasons, including rising Treasury rates, "as well as renewed discussions of federal tax reform and increasing credit risks from certain large issuers with lagging economies, structurally unbalanced budgets, and growing unfunded pension obligations."

Tax reform and pension underfunding are seemingly perennial low-level threats to the muni market. So far, there are few signs that the incoming Republican Congress will pick on munis as a possible source of new tax revenue. As for pension obligations, a five-year stock market bull run has helped make that seem like less of an imminent crisis, and problems remain isolated for now.

The constant through the past several years has been a low default rate, despite a handful of high-profile problems like Detroit's bankruptcy filing and Puerto Rico's continuing struggles. In fact, every year since 2010 has shown a decline in muni defaults, according to Matt Fabian of Municipal Market Analytics, who says "there may be still fewer defaults ahead for 2015, although we expect defaults are approaching a minimum or baseline level that will persist, regardless of economic conditions."

SHORTER-DATED BOND YIELDS have been rising amid expectations that the Fed will lift its policy rate this year. JPMorgan forecasts "strong but volatile" muni performance, as the yield curve flattens further, meaning short-dated yields rise more than long-dated ones. JPMorgan sees the best total return this year once again coming from longer-dated muni bonds, specifically those maturing in 21 to 25 years.

Shorter-dated bonds could see further price declines if short-term rates continue to rise. If yields do climb, however, they should become more tempting to investors who use laddering strategies that buy individual bonds of varying, staggered maturities.

“The pricing of earlier maturities has put significant incremental yield (and valuation) into bond prices inside of 10 years, and in particular inside of five years,” MMA’s Fabian wrote in late December. “This is perhaps the best opportunity in years for retail holders looking to repopulate [the] front end [of] income ladders.”

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