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Municipal Bonds: What Comes After Perfect?

As records go, you can't beat 12 for 12. Perfection is good … and bad.

Muni investors enjoyed a perfect run in 2014 as the market notched a positive return each and every month, leading the S&P Municipal Bond Index to an annual return of 9.26%.

What could be bad about that? It sets some pretty lofty expectations for 2015. I'd like to provide some context and perspective for investors.

The Stars Aligned in 2014

The stars aligned in spectacular fashion for the municipal bond market in 2014: Low supply amid solid demand, improving fiscal conditions among state and local issuers, and a broad drop in interest rates (and rise in bond prices) helped make munis one of the top-performing fixed income asset classes of the year.

Many of the favorable dynamics remain firmly intact at the start of 2015. But we don't expect 2015 to be a 2014 repeat, if only for the simple fact that munis aren't built to provide 9% returns. They are intended to be a high-quality, relatively low-volatility source of income. Also consider the fact that the Federal Reserve is likely going to start raising interest rates this year, and that will create volatility and some measure of uncertainty for all fixed income assets.

What Is in the Stars for 2015?

In setting expectations for 2015, a look at long-term patterns is informative. Historically, returns in the year following a bounce back year (and yes, 2014 was a big bounce from a dismal 2013) have been two-thirds lower than the bounce. Given a return of 9.26% in 2014, that would equate to a return of roughly 3%-3.5% in 2015.

After the bounce

More importantly though, municipal bonds' income proposition remains very compelling. Long-term muni yields are attractive relative to Treasuries before tax, and especially after tax. At January 30, we had a 30-year muni yield of 2.50% vs. 2.22% on a 30-year Treasury. Pretty good. But factor in munis' tax exemption, and that's a 4.42% taxable equivalent yield on a 30-year municipal bond.* Really good. It's little surprise municipal bonds are attracting the attention of crossover buyers (i.e., taxable investors). We expect that crossover interest to continue, bolstering demand and supporting muni prices in 2015.

Tips for Investors

Against this backdrop, we'd offer a few key recommendations for investors:

Observe the curve. Yield curve positioning will be very important in 2015. The short end will be harder hit as the Fed raises rates. Greater value and lower volatility can be achieved further out. We like the 12- to 17-year area.

Hold onto high yield. High yield munis did even better than the broader muni market in 2014, but I still have a hard time poking holes in the investment case. Investor thirst for income is high, which suggests continued demand for high yield munis. There's also limited supply. Taken together, that makes for a favorable equation.

Avoid the extremes. Don't take on more risk than you can stomach, either by extending too far out on the curve and/or by taking excessive credit risk. At the same time, don't get too defensive. There's no value to be gained in exiting the market and holding cash today.

Use flexible fixed income. BlackRock is urging investors to rethink their bonds in 2015, and part of that means using flexible fixed income strategies to guard against interest rate risk and credit events, while also enhancing the diversification of your fixed income portfolio. In the tax-exempt space, we recently supplemented our Strategic Municipal Opportunities Fund with a new state-specific option in California .

In closing, I'd like to offer one final thought on this idea of perfection: It's overrated … and it's subjective. I enjoyed what munis had to offer in 2014, but I expect continued good things from the asset class in 2015. (But if you're still counting, one month down and "perfect" so far.) I invite you to read my fuller 2015 outlook and to check out our monthly municipal market updates to keep up on market performance and events throughout the year. Happy 2015!

Peter Hayes, Managing Director, is head of BlackRock's Municipal Bonds Group and a regular contributor to The Blog. You can find more of his posts here.

* Assumes highest marginal tax rate of 39.6%, plus the 3.8% tax on investment income under the Affordable Care Act.

By BlackRock, February 04, 2015

The opinions expressed are those of Peter Hayes as of 2/3/2015 and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of any individual holdings or market sectors.