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Muni Bonds WIll Survive Rate Hikes, Investment Managers Say.

Even though the price of money will increase sometime this year, municipal bonds should still have decent, if unspectacular, returns, investment managers said Tuesday.

“We feel that, despite rising interest rates, that we will still be able to have for municipal investors a low- to middle-single-digit return,” Greg Gizzi, senior portfolio manager for municipal fixed income at Delaware Investments said at a conference hosted by the firm in Manhattan.

Income, not appreciating price, is the key to obtaining good numbers in municipal bonds, he said.

The recent 10-year return on municipal bonds was 4.69 percent, according to the S&P Municipal Bond Index.

Gizzi’s prediction is based on his belief that income from the portfolio will offset any price drop due to the Federal Reserve increasing interest rates.

The modest interest rate increase will be accompanied by a flattening of the yield curve, he added.

The Fed, another Delaware manager said, now has the justification to increase rates.

“They have the cover to do so. The employment picture is clearly pretty strong,” said Brian McDonnell, senior portfolio manager, senior structured products analyst, Delaware Investments.

“If you look at a lot of the measures of inflation, while they don’t look like they are high enough or close enough to the Fed’s target to raise rates, one of the things they like to look at is inflation expectations,” he added.

McDonnell said that the expected inflation rate is 2.7 percent over the next year and about the same rate over five years.

McDonnell said the Fed increase comes at a time when most other central banks continue to ease money supply, which means the dollar will likely strengthen. So Delaware Investments is looking for bonds that can perform well in a deflationary environment.

But so far, Gizzi added, with the market already counting on the Fed rate hike, the environment has been good for muni bonds. That’s because many cities, towns and states have been cleaning up their balance sheets.

Delaware Investments has steered clear of problem spots, he said. It has no Illinois munis, noting that the effort of the new governor to correct its spending problems was recently nullified in court, although the state is appealing. Delaware Investments also has only one bond position in Puerto Rico, a hospital with a strong balance sheet, he said.

Gizzi also said that because the rate hike has been talked about for so long, it will already have been discounted by the market by the time it happens, possibly in June.

What could happen to interrupt his scenario?

Unexpected events, he added, are the greatest potential problem. It depends, Gizzi said, on the way in which interest rates are increased by the Fed.

“Are we going to see a gradual rate rise where the curve shift is flatter,” Gizzi asked, “where income is going to drive the day? Or are we going to see a severe spike in rates and the long end of the curve steepen out?”

Gizzi doesn’t expect the latter.

What about tax reform changing the climate for municipal bonds or bonds in general, such as inversions or corporate tax reforms?

Substantial tax changes, Gizzi said, won’t happen until the next administration takes office in January 2017.

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