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Muni Bonds are Poised to Shine as Rates Move Higher.

As the Federal Reserve inches toward its first interest-rate hike in nearly a decade, some market watchers see the municipal bond market as uniquely poised to outshine the taxable fixed-income space.

Thanks largely to a guilt-by-association with high-profile trouble spots like Puerto Rico and Chicago, much of the $3.7 trillion muni bond market is boasting yields close to or above comparable taxable bonds.

The 10-year Treasury bond, for example, is currently yielding 2.1%, which compares to a 2.63% yield for the iShares National AMT-Free Muni Bond ETF (MUB).

“The yields are so high because there’s a cloud hanging over the muni market, and people are throwing out the baby with the bathwater,” said Ron Bernardi, muni bond trader and president of Bernardi Securities.

“Right now the supply of quality munis is insufficient to meet demand,” he added. “I don’t think you’ll see mid- and long-term munis move as much as taxable bonds when rates rise.”

The yield anomaly, considering that muni bond yields historically hover around 85% of taxable equivalents, creates a kind of buffer for muni bonds when prices start to fall across the bond market as rates move higher.

But fixed-income experts say that buffer is just part of the case for munis in the much-anticipated rising-rate cycle.

“Muni bonds would do better in a rising-rate cycle for a variety of reasons,” said Dan Heckman, senior fixed-income strategist at U.S. Bank Wealth Management.

He cited growing property-tax revenues as a positive influence on muni bonds, which represents the income for much of the muni bond market.

“There’s typically about a three-year lag, with reassessments and rising property-tax revenues,” he said. “Even in a rising-rate environment, property-tax revenues are going to rise.”

To be clear, the multi-year quantitative-easing program that is still artificially holding down interest rates has created an unprecedented scenario for the financial markets in general, and fixed income in particular. But as the markets brace for what could be a rate hike this year, the muni market at least appears to be the safer bet.

“Rising rates, by definition, will be problematic for fixed income, but the muni market is very different from the Treasury and corporate bond markets,” said Jeff Hudson, a partner at Cedar Ridge Partners.

“Munis, which are 70% owned by mom-and-pop investors, are almost automatically less volatile because retail investors tend to react slower," he added.

Another changing dynamic in the muni bond space is the dramatic reduction in rated and insured issuances, which are now down to about 30% of all fixed-income issuances, from close to 70% prior to the financial crisis, according to Mr. Hudson.

"People used to buy munis just based on ratings, [but] now they have to actually look under the hood and understand what's going on with the credit, which has made the muni market more credit-driven and less rates-driven," he added. "It's too simple to make any big predictive statements about what the muni market will do when rates rise, because we really don't know."

The closest thing there is to a beta test on a rate hike is short stretch of mid-2013 when the Fed tested the bond market with the idea of reducing the multi-trillion-dollar quantitative-easing program.

The so-called taper tantrum, from May through mid-September 2013, was essentially a knee-jerk reaction from investors.

From May 1 through Sept. 15 of that year, the S&P 500 Index gained 6.6%, the Barclays US Aggregate Bond Index lost 4.2%, the 10-year Treasury declined by 8.2%, the iShares muni bond benchmark ETF fell by 7.8%, and muni bond mutual funds declined by an average of 5%.

By that brief example, it does appear muni bonds are likely to hold up slightly better through a rate hike.

"The 10-year Treasury can be quite volatile, because people tend to jump in and out of it, but munis are still primarily purchased by retail investors and that makes them less likely to act like trading vehicles," said Tom Dalpiaz, managing director at Granite Springs Asset Management.

"The tax exemption alone, in some sense, almost means they are going to be less volatile," he added.

Jim Colby, senior municipal strategist at Van Eck Global, said nothing has been more anticipated than the upcoming Fed rate hike, and the bond markets are likely prepared for it. But that doesn't mean investors won't try and avoid the pain by selling bonds as rates rise.

"You might have investors and advisers very much concerned about the impact of rising rates on bonds and the inverse impact on bond values," he said. "Some people will feel they should exit munis because they don't want to see the book losses as rates rise, but if you exit munis you're giving up the tax-advantaged coupon."

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