

Bond Case Briefs

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More Reason to Love Munis.

Municipal bonds had a strong 2015, but low oil prices and a volatile stock market will cause many states to struggle. Even so, munis seem like a good bet.

Investors who liked municipal bonds in 2015 are really loving them so far in 2016. Munis had the highest returns of any fixed-income sector last year, and are shining brighter than ever as stocks have been roiled by concerns about slowing global growth.

"Munis have started off the year with an unexpected surge, not only in performance but also in popularity," says Jim Colby, municipal strategist at Van Eck Global.

That's great for investors who own munis, but if you're looking for a safe place to hide as equities turn treacherous, note that the easy money in munis may have already been made. "They've gotten to levels that are a bit rich relative to Treasuries," admits Hugh McGuirk, who runs municipal bond investing at T. Rowe Price. In recent years, 10-year muni yields were very close to Treasuries, which made them much more attractive on an after-tax basis. Now, intermediate munis yield about 85% of Treasuries. For example, seven- to 12-year munis yield, on average, 1.7%, versus 2% for the 10-year Treasury. The tax benefit still makes munis attractive, but not as much.

"It dampens my enthusiasm moderately," McGuirk says, "but I still see the benefits of munis as a very defensive investment when global markets are volatile."

Limited supply of new munis in November and December is a big reason why they outperformed Treasuries late last year, says Vikram Rai, Citi Research muni strategist. But now new issuance is picking up. "That will cause munis to cheapen slightly," he says. There will be better entry points for new investors after January, he believes.

THERE ARE OTHER looming risks muni fans should keep in mind. A couple are well known: Puerto Rico will likely default on billions in debt this year, and some states, like New Jersey and Connecticut, have growing pension liabilities they need to address.

But Standard & Poor's highlighted additional worries for state finances in a report issued last week. Energy-producing states like North Dakota, Louisiana, and Oklahoma are likely to face particular fiscal strain as companies scale back on production in response to the crash in crude oil prices. Alaska has already been downgraded. Pennsylvania and Illinois are in political gridlock over budgets. Plus, some states can expect less revenue growth, due to lower capital-gains income (fewer investors are selling at a gain). S&P has a negative outlook for seven states, which means they may be downgraded in the future. "The state sector is currently poised for some volatility in terms of credit," says Gabriel Petek, the main analyst on the report.

Active municipal bond-fund managers say credit research—their long suit—can manage those risks. "We're continuing to emphasize revenue bonds over general obligation bonds, in no small part because of concerns about state and local governments addressing long-term liability issues," says McGuirk. Peter Hayes, who heads the muni bonds group at BlackRock, says he's taking a barbell

approach to credit risk, buying high-yield munis, such as tobacco bonds, as well as A-rated revenue bonds.

At least interest-rate risk has dissipated. Last year, concerns that the Fed was about to embark on a rate-hike cycle dampened muni demand. Now, even as the new-issue calendar builds, Hayes expects demand from investors to absorb the new supply. Rai expects muni rates to nudge up this year, but thinks the coupons earned on most maturities (except for the 10-year) will result in positive 2016 returns.

It makes sense for investors looking for safety to turn to munis. But chasing the recent strong performance could result in disappointment. "Munis aren't quite as attractive as they were a year ago," concedes Colby. "But they still have a lot going for them—including very high average credit quality and significantly lower volatility."

Given how markets are acting, that's a pretty good argument for owning them.

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