Bond Case Briefs

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Municipal Bonds Start to Stumble.

Muni bonds have been terrific investments, but as demand has risen, they've grown expensive. Investors should be cautious.

Municipal bonds have been terrific investments for the past year. The average national intermediate muni-bond fund is up more than 5% in that time, with the best performers topping 8%. Since munis are tax-advantaged, those returns are even better.

But with that magic combination of safety and yield, munis have also been in huge demand—and have gotten expensive. Yields, which move inversely to prices, are lower, especially relative to Treasuries.

It was only a year ago that high-rated munis yielded more than Treasuries in longer-term maturities. Now top-rated 10-year munis yield about 1.5%, less than the 1.8% yield on the 10-year Treasury note. Mid-month, long-term munis hit 2.4%, near their lowest yields in history, says Vikram Rai, who heads municipal strategy at Citigroup.

Now the Federal Reserve is threatening to raise rates this summer. Following the May 18 release of minutes from the Fed's April meeting, Treasury prices fell, as did prices of high-quality munis. An increase in new supply also contributed to munis' recent dip—and that could be just the start.

"These yields are at such low levels that I think the muni market offers very little protection against a rise in rates over the next 12 months," says Jim Kochan, chief fixed-income strategist at Wells Fargo Funds. Even though munis won't move as much as Treasuries, if and when the Fed hikes, fund investors could see negative returns, he warns. Of course, investors who hold individual muni bonds to maturity needn't worry about falling prices.

Riskier high-yield munis haven't fallen in price—in fact, they are getting more expensive. Nicholos Venditti, a muni-bond portfolio manager at Thornburg Investment Management, worries that muni investors are overloading on lower-quality and long-term bonds. "If and when there is a reversal, investors who are stretching for yield in an environment where they are not being adequately compensated are going to get hurt the most," he warns.

Fans believe huge demand will keep muni funds afloat. But supply is building as municipalities take advantage of extremely low rates. Kochan warns that the investor appetite for munis—which has spurred massive inflows into muni-bond funds—can reverse quickly if prices start to fall.

NONE OF THIS MEANS investors should rush to sell munis. But those with new money to deploy should note that high-quality corporate bonds yield upward of 3%, more than munis even after taxes are taken into account, says Michael Sheldon, chief investment officer at Northstar Wealth Partners.

Reducing risk by buying shorter-term, higher-quality munis makes sense for investors who stretched for yield. "Stick with quality," says Jim Grabovac, a senior portfolio manager at McDonnell Investment Management. "That's the best defense against a rocky rate environment."

Constructing a laddered portfolio, made up of bonds with a range of maturities, is a good strategy in a rising-rate environment since each year a new crop of bonds matures and can be reinvested at higher rates, says Sheldon. Venditti manages the Thornburg Limited Term Municipa l fund (ticker: LTMFX), which ladders bonds with an average maturity of less than five years.

Citi’s Rai prefers a barbell approach—one which favors both short-term and long-term bonds—since it allows investors to benefit from a flattening yield curve. If the Fed hikes, longer-term bond yields are likely to fall, gaining in price. While short-term yields would rise, they wouldn’t lose much value because they have very low duration.

Rai doesn’t think muni yields will rise much since extremely low—and negative—rates around the world will keep a lid on rates in the U.S. He also thinks that munis may rally if the Fed doesn’t hike this summer. Still, investors may want to play it safe by giving up some yield and taking less risk.

BARRON’S

By AMEY STONE

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