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Muni-Market Mainstay Seen as Cushion When Fed Does Raise Rates.

When the Federal Reserve gets around to raising interest rates, bond buyers may find some shelter in a mainstay of the municipal market.

Investors should consider purchasing high-coupon state and local debt that governments have the right to buy back at face value in the future, Alan Schankel, a managing director at Philadelphia brokerage Janney Montgomery Scott, wrote in a report released Monday. While the securities are trading well above par — exposing holders to losses if they're forced to sell them back for 100 cents on the dollar — the higher interest payments mean the bonds won't fall as much as others when the central bank moves.

Such debt, known as cushion or kicker bonds, typically pays periodic interest at a rate of 5 percent, a level Schankel said has because "almost ubiquitous." When the price is factored in, that leaves a yield of 2.14 percent for securities that are called in 9 years, amost half a percentage point more than benchmark 9-year debt, according to Schankel.

"The potential for higher yields combined with the defensive nature of cushion bonds make them worthy of consideration for most municipal-bond portfolios, especially with tax-free interest rates hovering near a 50-year low," Schankel wrote.

Investors are expected to have time to prepare their defense. The futures market predicts there's only a 20 percent chance that the Fed will lift its overnight lending rate when it meets on Wednesday. Policymakers have held the benchmark steady since December, when it was raised for the first time since 2006.

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by Romy Varghese

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