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Has the Municipal-Bond Bull Left the Ring?

NEW YORK — The great bull run for the municipal-bond market may be running out of juice.

For the past year, bonds issued by state and local governments have been red-hot investments. Muni-bond mutual funds have had 53 straight weeks of inflows, according to the Investment Company Institute. That's one of the longest streaks on record, and they attracted cash at the same time that investors were leaving stock mutual funds. Even Puerto Rico's default on its debt and Britain's vote to exit the European Union, which roiled bond markets worldwide earlier this year, didn't interrupt the muni market's trajectory.

"Munis have been the darling asset class of the past two or three years," says Chris Alwine, head of the municipal group at Vanguard.

Now there are signs that this long bull run may be coming to an end. After 10 straight months of positive monthly returns, the iShares National Muni Bond exchange-traded fund, the largest muni ETF by assets, posted a very narrow loss in July. While returns were positive in August, the fund lost about 0.6 percent in September and is on track for another loss in October.

Munis have always appealed to U.S. investors, who are attracted to their reputation for safety and the fact that their income is free of federal income taxes. It's an incentive offered to get investors to lend to local government so they can build schools, highways and sewer systems. In some cases, income from muni bonds is also free from state or local income taxes.

Over the past 12 months, the iShares ETF has returned 4.3 percent. That beats the returns for the largest bond mutual fund, Vanguard's Total Bond Market Index fund, which returned a nearly identical amount, after taking into account the tax savings.

In the past couple of years, low interest rates around the world and a volatile stock market have also driven investors from outside the United States into the municipal-bond market, even though non-U.S. residents don't get the tax advantages.

Given how high prices for muni bonds have moved, some fund managers say that a pullback is inevitable. The 10-year yield on the AP Municipal Bond index, which moves inversely to bond prices, hit a low of 1.69 percent in July and has been climbing ever since. It ended last week at 1.878 percent. Even the relatively small increase in yields has put downward pressure on prices of municipal bonds, says James Kochan, chief fixed-income strategist at Wells Fargo Funds Management.

If many of the recent muni buyers have been coming with the intent of avoiding turmoil elsewhere in the bond world, a few months of negative returns for munis could spark a sell-off.

It wouldn't be the first time that investors in munis, a historically sleepy market, have been spooked in recent years. The most recent case was in the 2013 "taper tantrum," when investors became anxious about the possibility of an upcoming interest-rate increase. When investors dumped muni bonds during that episode, prices quickly dropped. The iShares ETF lost 8 percent in just four months.

“I think some investors are taking more risk than they are aware of,” says Chris Ryon, portfolio manager at Thornburg, who co-manages one of the largest muni bond funds.

Given the uncertainty, investors who hold munis should be looking to pare back on risk, says Ryon, who suggests sticking with higher-quality muni offerings, especially because lower-rated muni bonds aren’t offering that much more income than higher-quality muni bonds. In the parlance of bond investors, the “spread” is not that wide.

With that said, there’s no need to ditch high-yield munis entirely, says Peter Hayes, head of the municipal bonds group at BlackRock. “For the rest of the year, we think returns will be largely generated by income,” he says. “That means you need to own some amount of high-yield.”

Investors should also shorten the duration, or maturity, of their holdings, says Wells Fargo’s Kochan, because prices of longer-term bonds tend to fall more when interest rates rise.

Hayes says he favors 15-year maturities, which he calls the “sweet spot.” The good news for investors: With global interest rates still extremely low and the credit quality of munis generally stable, most experts view the recent dip as a pullback, not the start of a bear market.

Says Hayes: “The past month has created a little bit of better buying opportunity.”

By THE ASSOCIATED PRESS

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