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Municipal Bonds: What to Do as Prices Drop.

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Municipal-bond investors face a conundrum. The spike in interest rates since the election has made long-term tax-exempt bonds more attractive than they've been in years. You can now buy highly rated 10-year munis yielding near 3%—more than Treasuries and high-quality corporate bonds. That's equivalent to a 4% taxable yield for investors in a high tax bracket.

Yet higher interest rates are a two-edged sword. At the same time, muni prices are falling. As of Friday, the benchmark-tracking iShares National Muni Bond exchange-traded fund (ticker: MUB) had a negative 1% year-to-date return. (At the end of October, it had been up 2.3%.) For investors who bought muni funds this year, harvesting tax losses makes sense. Bond-fund outflows, which began in the past two weeks, are likely to pick up into December.

The pro-growth fiscal-stimulus plans of President-elect Donald J. Trump, such as lower tax rates (which could crimp demand for munis) and higher infrastructure spending (which could increase supply), are particularly worrisome for munis. With the Federal Reserve poised to hike rates in mid-December, the near-term outlook is bearish—even though many observers believe "the selloff in munis has gotten too extreme," as Dan Heckman, fixed-income strategist at U.S. Bank Wealth Management, puts it.

His solution: Implement a barbell strategy—that is, invest in both very short-term and longer-term munis. The long end (think 10-year, not 30-year) boosts the portfolio's income, while the short end provides stability if rates keep rising. Conversely, if the economy slows and rates fall, the longer-term bonds will outperform shorter-term bonds and provide a buffer from declines in riskier assets, such as stocks and high-yield bonds.

Rumblings from the Federal Reserve make this strategy more compelling. "A December hike is almost a foregone conclusion," says Paamco senior credit strategist Putri Pascualy. "The path of rate hikes after that is highly uncertain." Economic growth is picking up at the same time Trump's stimulus plans are taking shape, which could mean a more-aggressive rate-hike path next year. That would likely cause the yield curve to flatten, with long-term bonds rising in price, as inflation expectations fall, while short-term bonds dip.

INVESTORS WHO HAVEN'T looked at ultrashort-term muni rates may find them surprisingly attractive. Yields of ultrashort-muni and tax-exempt money-market funds have already climbed from nothing to something this summer due to the impact of money-market reform, which triggered massive outflows, says Colleen Meehan, who directs muni-money-market-fund strategies at BNY Mellon. These funds mostly own seven-day floating-rate tax-exempt securities whose yield this year has jumped to 0.55% from 0.01%. The expected Fed December rate hike of 0.25 percentage points should increase these yields, she says.

Peter Hayes, BlackRock's head of municipal-bond investing, suggests investors put new money in ultrashort muni funds or keep a cash cushion. He also likes 15-year munis, which have 87% of the yield of the longest-term bonds. For investors who want to be tactical, Thomas Byrne of Wealth Strategies & Management recommends keeping maturities very short for now and moving to longer-duration bonds as fund outflows pick up.

Munis in the two-year maturity range will get hit hardest by Fed tightening, says Jim Grabovac, senior portfolio manager at McDonnell Investment Management. He recommends that long-term investors extend maturities now. He isn't too worried about Trump's proposals. Even if they come to fruition, he says, the muni market has weathered marginal tax-rate reductions and increases in supply just fine in the past.

"Some of this reaction is overdone, and near term, it provides an opportunity to do some portfolio restructuring and curve extension," Grabovac says.

Barron's

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November 26, 2016