[Bond Case Briefs]

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[Fall, Recover, Repeat: Munis Rebound From Sharp Drops, Again.]

NEW YORK — So much for that sleepy reputation.

The municipal-bond market used to be a reliably boring one, full of small cities, state governments and others borrowing to build sewers, roads and hospitals. But in the last decade, the muni market has been all-too-interesting and whipped investors through several sell-offs.

The latest struck in November, when the largest muni-bond fund had its worst month since the 2008 financial crisis. It lost 3.4 percent on worries that the incoming White House and Congress would cut tax rates and pursue other moves that could weaken muni bonds' appeal. Since then, though, muni funds have clawed back about half their losses and look to be on their way to erasing yet another downturn.

"That's the nature of the muni market, it overreacts," says James Dearborn, head of municipal bond investments at Columbia Threadneedle.

Looking ahead, muni fund managers say they expect the market to remain interesting. Volatility will likely remain as Washington continues to debate changes to the tax system. Returns, meanwhile, will likely be lower than in past years, but managers say they can still grind out modest gains.

"What the last two years have taught us is: Don't panic," says Hugh McGuirk, head of municipal bonds at T. Rowe Price.

Few were taking that advice in November, after Republicans swept elections for the White House, Senate and House. Prices for all types of bonds fell on expectations that faster economic growth and inflation may be on the way.

Munis fell even more on fears that some proposals would directly hit the market, chiefly a rewrite of the tax code. "Any time you talk tax reform, the muni market quivers," McGuirk says.

The income that municipal bonds pay can be exempted from income taxes. That's why investors buy a muni with a lower yield than a similarly rated corporate bond, because the return will be better after taxes. Tax reform could put the exemption in the crosshairs. Even if it survived, muni bonds could be hurt if tax rates dropped and diminished the exemption's benefit.

Beyond that, investors worried that a big infrastructure program from Washington could mean a deluge of new municipal bonds hitting the market and overwhelming demand from buyers.

November's tumble in prices for munis followed earlier sell-offs, such as in 2010 and 2013. But this past one didn't last as long as those.

"That was the most interesting part of this particular sell-off in November, how quickly it reversed," says Karl Zeile, portfolio manager at Capital Group. "It really lasted only about four weeks, and then the market woke up to oversold valuations and started moving.”

Part of it is who was doing the buying. The muni market is usually dominated by individual investors, who can be prone to follow the tide. Prices for munis eventually fell enough that hedge funds and other big institutional investors got interested and helped set a floor.

On top of that, it’s becoming clear that change could be slower to occur in Washington than initially expected, if it happens at all. Republicans last month pulled their proposal to revamp the nation’s health care system due to a lack of support.

“Taxes are even more difficult than health care,” says Peter Hayes, head of the municipal bonds group at BlackRock. “The complexity of the tax code and difference of opinion tells us that it’s more likely to be later than sooner.”

Even if tax reform and an infrastructure program do pass, the effects may not be as bad for the market as many had feared. A drop in the top tax rate would likely hurt muni bond prices but doesn’t have to be a catastrophe. Munis held their own after President George W. Bush enacted tax cuts in 2001, for example. And the federal government could make sure bonds for infrastructure get issued outside the tax-exempt market.

Now, regular investors are coming back to the market. They’ve put more money into muni funds than they’ve taken out for three straight months, after fleeing in November and December.

So, how much is fair for them to expect in returns?

One benchmark index that many muni funds follow has already returned close to 1.7 percent in the first quarter of the year. Don’t except that every quarter.

Broad muni funds generally have yields around 2.5 or 3 percent, and returns for 2017 will likely be close to there, managers say. The 10-year yield on the AP Municipal Bond index is 2.54 percent.

Volatility is also likely to remain. The Federal Reserve is in the midst of raising rates off their record lows, and higher rates knock down prices for all kinds of bonds. If the Fed can stick to its promise to move slowly and modestly, bonds can continue to chug along. But if the economy and inflation pick up their pace, the Fed would have to get more aggressive.

And prices could quiver again as talk inevitably heats up on tax reform. When that happens, though, managers say they don’t expect the drop to be as steep as in November.

“The muni market has become less sleepy,” Hayes says. “People understand that these big sell-offs represent buying opportunities.”

By THE ASSOCIATED PRESS

APRIL 6, 2017, 3:16 P.M. E.D.T.