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Municipal Bonds Attractive Again as Trump Euphoria Wanes: Pimco

Policy stumbles can be bullish for munis

Municipal bonds are starting to draw investor interest as investors take in President Donald Trump's early pro-growth-agenda stumbles, said David Hammer and Matthew Sinni, credit strategists at bond giant Pimco.

"While we think it's too early to shout 'all clear,' investors now have more information about policies likely to affect the municipal bond markets this year, and relative valuations are looking more attractive than they did a few months ago," they said in a note.

After Trump's election, munis were pummeled by fears that his agenda of large fiscal stimulus measures, including tax cuts, could pare demand for municipal securities. The prospect of tax changes could dull the attraction of those securities, which depend on investors looking to benefit from the income-tax exemption munis offer.

However, a failure to repeal and replace Obamacare, along with a lack of specifics on Trump's tax plans, have cast doubt on the president's ability to easily implement his policies. Trump's troubles, which comes despite Republican control of the Senate and House, has contributed to a bullish environment—at least for the moment—for muni bonds, the Pimco strategists said.

"Slower-than-expected policy progress and a Republican majority that lacks a unified vision for health care or tax reform make it more likely that an eventual fiscal boost won't occur until 2018 (and may be smaller than initially expected)," they said.

"The upshot is a tax reform backdrop for municipals that, while not without risk, has modestly improved since the beginning of the year and (if realized) would not fundamentally alter the long-term valuation paradigm for tax-efficient investors," they said.

Also, the relative value of munis versus Treasurys is also compelling, they said. The municipal/Treasury yield ratio, a measure comparing Treasury TMUBMUSD10Y, -0.27% and municipal bond yields, is at 92%. Any number above the historical average of 80% is considered a sign municipal bonds are oversold and cheap compared with Treasurys.

Hammer and Sinni point out that high-yield municipals NHMAX, +0.00% for example, appear more attractive than high-yield corporate bonds HYG, +0.05% In 2017, the spread between high-yield municipal bonds and Treasurys surpassed that of high-yield credit, mainly because of a scramble for income against a backdrop of meager interest rates, with the 10-year Treasury benchmark offering a yield of 2.32%.

Funds focusing on municipal debt have notched a five-week streak of net inflows, according to data from EPFR Global.

Falling inflation expectations from lower energy prices also has helped spur appetite because lower consumer prices help to mitigate the corrosive effect of inflation on a bond's fixed payments. Signs of slack in hiring, which suggest that wages are holding lower, can also contribute to weaker inflation expectations.

So-called break-even levels for Treasury inflation-protected securities, that is, the bond market's estimation of expected inflation, have fallen. The five-year break-even rate, or average expectations over a five-year period, fell as low as 1.65% on April 18 from the two-year peak of 1.97% on Jan. 27, a week after Donald Trump had entered the White House, data from the Federal Reserve Bank of St. Louis shows.

To be sure, others argue different employment indicators could show an economy at full employment and that energy prices have only a fleeting impact on inflation. The jobless rate continues to stay at 4.5%, matching prefinancial crisis levels, and the Bureau of Labor Statistics reported wages had grown 0.8% in March.

MarketWatch

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