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When the Trump Agenda Loses Steam, Muni Bonds Gain Momentum.

Municipal bonds were supposed to be among the biggest losers under a Trump presidency.

Shortly after the November election, muni bonds — issued by states, municipalities and local agencies to finance government projects — faced a "triple whammy," said Terri Spath, chief investment officer at Sierra Investment Management.

First, there was a sharp rise in market interest rates late last year in anticipation of the new Trump policies boosting economic growth. And rising rates are a headwind for bonds in general. Then there was the president's pledge to lower income tax rates, coupled with concerns that he might eliminate the tax-exempt status of muni income.

And finally, President Trump has promised to increase infrastructure spending by possibly $1 trillion — which, if it happens, could flood the muni market with additional supply, weighing on the price of existing muni securities.

But it hasn't turned out that way so far.

"Here we are, several months later, and the administration has had problems getting anything done," said Nicholos Venditti, a portfolio manager who helps run several municipal bond funds at Thornburg Investment Management. "There's been no health care reform yet, no tax reform and no clarity on spending."

Meanwhile, concerns about a slow-growing economy have resurfaced, pushing the yield on 10-year Treasury notes back down to 2.3 percent at the end of June, from as high as 2.62 percent in March. And the Treasury secretary, Steven Mnuchin, recently told the Senate Finance Committee that the Trump administration supported preserving the muni bond tax exemption.

The result of all of these developments is that muni bond mutual and exchange-traded funds have enjoyed a surprisingly good run this year.

For instance, the SPDR Nuveen Bloomberg Barclays Municipal Bond ETF, whose biggest holdings include revenue bonds issued by the California State University system as well as the University of California, has generated total returns of 3.6 percent this year and 2.2 percent in the recently ended quarter.

Even before investors factor in the tax break (muni income is exempt from federal taxes and, in some cases, state taxes as well), that performance compares favorably with the 2.3 percent returns for the Vanguard Total Bond Market ETF this year and the 1.6 percent gains in the last quarter.

Going forward, though, navigating the muni bond landscape will get a whole lot trickier, money managers say.

Even if Mr. Trump cannot produce annual growth of greater than 3 percent, which has eluded the economy lately — or the 4 percent rate that the White House promised earlier this year — the administration is still planning to move forward on its efforts to cut taxes.

Ultimately, how much income tax rates eventually come down, if at all, will help determine the direction of muni bond prices. But the tax cut debate itself is likely to create short-term volatility for these investments.

What's more, muni investors are largely following a conservative strategy.

"You can see where investors are hiding out," says Mark R. Freeman, co-manager of the Westwood Income Opportunity Fund. "Everybody is bunched up at the short end of the curve," he said, referring to muni debt with a maturity of no more than five years.

That demand for shorter-term munis has made it harder to find great values. In fact, it has compressed the so-called yield spread — the gap between what short-term muni bonds are paying and what similarly dated Treasuries yield.

For example, the average high-quality two-year municipal bond is paying 1.06 percent, according to Bloomberg, while two-year Treasuries are paying considerably more: 1.36 percent.

By comparison, 30-year munis are paying virtually the same as Treasuries before the tax benefit is factored in: 2.87 percent before the tax break, versus 2.92 percent for equivalent Treasuries. And for someone in the 25 percent tax bracket, that 2.87 percent is actually the equivalent of a 3.83 percent taxable yield.

To be sure, long-dated bonds are susceptible to larger drops in price should interest rates rise. And with the Federal Reserve lifting short-term rates, taking on that much so-called duration risk by buying extremely long-dated bonds does not seem to make sense, money managers say.

Gregg S. Fisher, founder of the investment management firm Gerstein Fisher, says investors should remember a big reason for buying muni and other core bonds in the first place: "For the certainty that they present," he said.

That's why he suggests investors play it relatively safe for the foundation of a muni portfolio, by sticking with bonds that are from high-quality issuers with investment-grade ratings (reducing the risk of a default) and that mature in less than five years.

"Our preference for any client, no matter what state they live in, would not be to buy 100 percent of their bonds issued in any one state," he said. "You should diversify across the country," he added, even if doing so forgoes some state tax breaks.

Ajay Thomas, head of municipal securities at William Blair, agrees that investors should mostly be considering investment-grade municipal bonds. But he points out that as investors venture out to the lower end of the high-quality bond universe and the higher end of the low-quality world, they may start to see better opportunities.

"You're not necessarily seeing a big difference in yields if you go from a AAA-rated bond to a AA bond," he said. "But if you go below A, there's clearly some spread." He noted that there were some decent opportunities among munis related to health care and higher education in this category.

Ms. Spath of Sierra Investment Management also said that higher-yielding munis are worth a look.

Sierra sold all its muni holdings shortly after the presidential election last year, amid mounting pressures weighing on these investments, Ms. Spath said.

But in early January, as some of the reaction to the Trump victory subsided, the firm moved back into muni bonds.

Today, Sierra's municipal bond exposure is entirely in high-yield muni funds, she said.

"High-yielding municipals are currently yielding roughly the same as high-yield corporate bonds, and that doesn't make sense," she said, noting that many investors are totally overlooking the tax benefit these securities provide.

She said the firm preferred investing in munis through a fund, in part because of the diversification advantage but also because institutional buyers can often obtain better prices.

Among Sierra's top muni holdings is Nuveen High Yield Municipal Bond fund, with an average credit quality of BB, which is at the upper end of noninvestment grade bonds.

Nearly one third of that fund's holdings are in debt tied to health care or education and civic organizations. Among its top holdings recently were B-rated debt issued by the Chicago Board of Education at a coupon of 7 percent and AA-rated debt issued by the University of Kansas Hospital Authority with a coupon of 5 percent.

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