Bond Case Briefs

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Why Fears About Muni Bonds are Unfounded.

Municipal bonds are as resilient an investment as the U.S. has ever devised. Periodically, some fleeting crisis rips 10% or so from the value of muni bonds, which pay interest that is generally exempt from federal income taxes. Then, as sure as the sun rises in the east, prices stabilize and a powerful recovery ensues. Those of us who have chronicled this uniquely American success story for decades know how dumb it is to sell munis short (literally and figuratively).

This time around, the Republican zeal for tax-cutting and a GOP electoral sweep sent muni prices plunging post-election. The idea: Lower tax rates would diminish the relative attractiveness of tax-exempt interest.

But, as always, reality sets in. Political dysfunction means cuts in individual tax rates are becoming unlikely this year–at least, that's what the smart men and women who follow the bond market believe. Even so, "changes in individual tax rates have negligible impact on demand," says Ashton Goodfield, a tax-exempt fund manager for Deutsche Bank. Savers who have been content to collect reliable tax-free income for many years have little incentive to sell their bonds and trigger capital gains taxes.

Quick comeback. Municipals began to turn around last December, and the rally has continued this year. So far in 2017, munis show total returns that equal or beat those of most high-grade taxable bonds. Moreover, in the first half of 2017, only five of 208 Standard & Poor's muni indexes were in the red, and three of those involved Puerto Rico and the Virgin Islands, which are serious trouble spots but irrelevant to the big picture.

Investors would do better to focus on the $3.8 trillion of solvent state and local debt in circulation instead of on the trifling sums north of San Juan that are in or threatening to go into default. In addition, many experts, including George Friedlander, of Court Street Group Research, and Duane McAllister, of Baird Funds, point to the continued scarcity of high-quality tax-exempts. Muni bond issuance declined 15.4% in the first quarter of 2017 compared with the first quarter of 2016. Vastly more bonds are maturing or being redeemed before maturity than localities can match with new debt.

Anywhere you look, muni returns are healthy. So far in 2017, the sector leaders among revenue bond issuers are life care (nursing homes and continuing care communities for seniors), up 4.7%; toll roads, up 4.5%; and higher-education facilities, up 4.3%. State by state, the trends are also sound. S&P's State General Obligation index returned 2.7% in the first half, but GOs of prosperous and high-tax states, such as California, Colorado and New Jersey, gained more than 3%. Despite the run-up in prices, yields (which move in the opposite direction) remain generous. A Merrill Lynch index of munis with 12- to 24-year maturities currently yields 2.8%, equivalent to a taxable yield of 5.0% for someone taxed at the top federal rate.

If you have money to invest, consider buying newly issued school, highway and water authority bonds rated triple-B or better. Shares of closed-end muni bond funds that trade at discounts to net asset value (or right at net asset value) are another option. Among mutual funds, Fidelity

Intermediate Municipal Income (symbol FLMTX), a member of the Kiplinger 25 , is a solid choice. It yields 1.8%, equivalent to a taxable 3.2% for someone taxed at the top federal rate.

Some commonsense guidelines always prevail. Don’t buy bonds from impoverished cities and counties or anyplace losing population. Debt backed by prisons and grandiose retail-an--entertainment districts is also dicey. Otherwise, try as I might to find cause for concern, I just cannot yet. And I’m not sure that I ever will.

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