Bond Case Briefs

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The Tax Law Gives Municipal Bonds a New Allure.

For many people with hefty state and local tax bills, the new federal tax law gives municipal bonds a powerful new appeal.

That is because the new law caps the state and local tax deduction that can be claimed on federal returns at $10,000. For many households, that cap will outweigh any potential benefits from other changes in the law.

For such people, tax-free investment income becomes ever more valuable — and municipal bonds can fit the bill.

The interest income paid on municipal bonds is exempt from federal tax. And if you own municipal bonds issued within your state, the interest income can also be free of state (and often local) tax.

What's more, the economic backdrop for 2018 could make municipal bonds one of the better slices of the fixed-income market. Municipal bonds are less sensitive to interest rate changes than, say, Treasury bonds, whose yields have been rising as Federal Reserve interest rate policy shifts, and with glimmers of inflation getting off the floor.

A high-grade, 10-year municipal bond issue currently has an average yield of roughly 2.5 percent. That compares with a 3.3 percent taxable yield for someone in the 24 percent federal tax bracket, and 4 percent for a taxpayer paying the top federal rate of 37 percent. The taxable equivalent yield is even higher if the income is also exempt from a state tax.

By comparison, the yield on a 10-year Treasury bond is below 3 percent and the yield on the Vanguard Total Bond Market Index fund, which invests in taxable government and corporate bonds, was recently only 2.5 percent.

Despite the appeal of munis, though, you need to be careful: The muni market can be tricky.

For one thing, amid fiscal belt tightening since the financial crisis, the pace of new municipal bonds hitting the market has declined. The tax law revision also eliminated advance refunding issues, a type of municipal bond financing that accounts for around 15 percent of the market, intensifying supply constraints.

At the same time, individual investors own about 70 percent of the municipal bonds, and demand from them seems likely to remain strong. Morningstar Direct reported $34 billion in net inflows to municipal bond funds and exchange-traded funds in 2017 — even before investors in high-tax states had the chance to huddle with their advisers to assess the impact of the new tax law.

With hungry investors chasing a smaller pool of municipal issues, the prices of bonds are likely to be bid higher. (In the world of bonds, yields move in the opposite direction from prices; so higher bond prices mean lower yields.)

That pressure has already caused the yield difference between municipal bonds and comparable

Treasuries to widen — reducing the muni advantage. For much of the last decade, the tax-free yield on a 10-year high-grade municipal bond was at least 90 percent of the taxable yield on a 10-year Treasury. That ratio is now down to the low 80s. Hugh McGuirk, head of the municipal bond team at T. Rowe Price, expects that this ratio will “be even under more pressure” as a result of these supply and demand issues.

Municipal bonds issued within your home state can be enticing because of the extra tax features. Around one-quarter of the nearly $700 billion in muni bond funds and E.T.F.s is invested in single-state portfolios, according to Morningstar Direct.

But Adam Stern, co-head of research at the fixed-income specialist Breckinridge Capital Advisors, cautioned that sticking with in-state issuers could be difficult. “In California, where there are hundreds of different issuers, you can create a pretty-well-diversified portfolio. But a state like New Jersey is a little tougher. With fewer issuers, it’s harder to figure out a diversified portfolio.”

Mr. McGuirk said the national funds run by T. Rowe Price usually own issues backed by 250 to 300 guarantors, compared with just 60 to 80 for single-state funds. Owning out-of-state bonds in a national fund can provide diversification, though you will pocket only the federal interest-income tax break, and have a liability for state and local taxes. Bonds from five states account for about half the assets in the Fidelity Intermediate Municipal Income fund, which has a recent yield of 2.6 percent.

High-yield municipal bonds carry more risk, but John Miller, co-head of fixed income at Nuveen Asset Management, expects them to have a solid 2018, mainly because he does not see a recession on the near-term horizon. With low unemployment and rising home values, the vast majority of municipalities are seeing tax revenue increase.
“Ninety-nine percent of last year’s default were in Puerto Rican issues,” he said. “All other defaults were less than $1 billion.” That’s a rounding error in a $3.8 trillion market.

Actively managed high-yield muni funds actually invest mainly in high-grade issues, with a heavy seasoning of high-yield. The average high-yield municipal fund currently has about 60 percent of its assets parked in investment-grade bonds, according to Morningstar Direct. T. Rowe Price Tax-Free High Yield fund, which earns a top Morningstar analyst rating, currently has about 62 percent invested in high-grade issues. Vanguard High-Yield Tax Exempt fund has more than 80 percent invested in high-grade bonds. Still, both portfolios have current yields above 3.7 percent.

Troubles loom on the horizon, though.

Underfunded state and local pensions are a festering issue for muni bonds. Chicago’s woes are well known, but even New York City is under some financial pressure. The fiscal health of issuers determines their credit rating; if that rating falls, so will the price of its bonds.

Moreover, the $10,000 federal cap on state and local tax deductions may make it harder for local officials to sell tax increases. If residents balk at higher taxes, future revenue increases will increasingly be generated through less-predictable fees and fines. Over time, that sort of shift could impair a city’s or state’s financial health. “It may be a subtle year-over-year change where the cumulative impact over a decade could be meaningful,” said Mr. Stern of Breckinridge.

That would hurt general obligation municipal bonds, which are backed by the taxing power of a municipality. Mr. McGuirk of T. Rowe Price said that while these bonds account for about one-third of new muni issues annually, his firm’s municipal bond funds usually have 15 percent or less invested in them.

“That’s our long-term concern, baked in for the challenges of state and local issuers to finance obligations,” he said. It is a concern that seems to be shared by many managers; according to Morningstar Direct, the average muni fund allocates 15 percent to those bonds.

Another type of muni, a general revenue issue, is an alternative. Such bonds rely on the income generated by a specific project, like a water and electricity project. That income source could be quite reliable, because households and businesses are likely to keep paying their utility bills. For households now facing higher personal income tax bills because of the reduction in the state and local income tax break, these bonds might rate as essential tools to generate tax-free income.

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