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What Municipal-Bond Investors Should Do Now.

Changes to the U.S. tax code have been good for the state and local government debt market—possibly too good.

Individual investors have been putting cash into municipal bonds at a near-record pace this year, in search of tax-exempt interest income to offset larger tax bills. For fund managers, a flood of cash into a market is normally a reason to celebrate. But they have a problem: State and local governments haven't been issuing enough new debt to match the increase in demand.

In effect, the new tax law has kicked off a competition among investors to finance state and municipal spending. That has reduced borrowing costs for states, but made it tougher for muni-bond investors to find deals.

"I get that taxes stink, and we all hate paying them, and we hate them even more every April because that's when it's the most real for us," says Nick Venditti, managing director at Thornburg Investment Management. "But we've managed to drive up valuations to levels that are probably unsustainable."

The U.S. Tax Cuts and Jobs Act capped the amount of state and local taxes that Americans can deduct from their federal tax bills. Investors in high-tax states have been loading up on municipal debt to offset their higher state and local tax bills.

While that demand would push muni yields lower—and prices higher—on its own, another tax-law change has made it more difficult for state and local governments to take advantage of those lower rates by refinancing their existing bonds.

Until recently, local governments could refinance debt well ahead of its maturity or call date in a process called "advance refunding." But the new tax law imposes taxes on the interest paid to holders of advance-refunding municipal bonds, which has essentially killed that part of the market, strategists say.

Now, by at least one measure, muni bonds are more expensive than they have been in over a decade. On April 16, 10-year benchmark muni bonds yielded 1.965%, while 10-year Treasuries yielded 2.6%. That is the widest gap since at least 2009, according to Bloomberg data.

Because the law raises tax bills most for the residents of high-tax states, demand for bonds issued by those states—California and New York, in particular—has climbed especially far.

Consider a $306 million bond recently issued by California's Department of Water Resources, which manages the state's dams and aqueducts. Its 10-year bonds sold at a yield of 1.73%, well below even the 10-year benchmark rate.

For investors who already own muni bonds and plan to hold them to maturity or their call date, there are worse fates than a nearly 2% tax-free coupon and paper losses.

But those looking to put cash into cheaper corners of the market may want to consider taxable muni bonds, says Robert DiMella, co-head and senior portfolio manager at MacKay Municipal Managers. That category includes securities like pension bonds, industrial development bonds, some hospital bonds, and Build America Bonds.

“The need for income is strong, and a lot of people are starting to worry about the corporate debt market,” says DiMella, and that makes taxable munis attractive.

Another option is to invest in closed-end mutual funds that hold municipal bonds. Many of them trade at a healthy discount, even though the Federal Reserve isn’t expected to raise interest rates for most of this year. The BlackRock Municipal 2030 Target Term Trust (ticker: BTT), a previous *Barron’s* recommendation, still offers a 9% discount.

Thornburg’s Venditti recommends that investors keep their cash in short-term high-quality municipal debt or floating-rate short-term securities called variable-rate demand obligations, or VRDOs.

“The best place for investors to be is shorter duration, higher-quality credit, so when opportunities present themselves, they have the flexibility to take them,” he says. “You can’t really set it and forget it.”

Barron’s

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April 19, 2019 7:30 a.m. ET

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