Bond Case Briefs

Municipal Finance Law Since 1971

Baird Funds Downgrades View on Municipal Bonds but Remains Bullish.

Baird Funds has downgraded its view on municipal bonds but remains bullish on the sector, citing smaller-than-expected revenue declines for states and attractive yields compared with taxable Treasuries.

The Baird downgrades follow a trend of Wall Street firms lowering their views on munis as a result of elevated prices. This month, BlackRock noted that it had reduced risk in its muni exposure "given stretched valuations and the potential for increased volatility in the fall."

Meanwhile, Morgan Stanley Wealth Management noted that "credit-rating downgrades will likely, and fairly, ensue due to some of the pandemic's surprising impacts" and that investors should emphasize stable, AA-or-higher "essential" credits, and "stay close to professional Financial Advisors."

Munis have stormed higher partly because of Federal Reserve support. In a recent Barron's article, we outlined the risks for all 50 states as local and state governments struggle with the pandemic, but noted that muni-bond prices have been surging, the result of the sector's solid performance in past periods of stress.

Investors have also been bidding up prices for high-yield municipal bonds, so that the spreads for bonds rated double-B-plus or lower is now just three percentage points above triple-A-rated munis, compared with seven points in 2009, during the financial crisis.

In downgrading their view to Strong from Very Strong, Duane McAllister and Lyle Fitterer—who help run the Baird Short-Term Municipal Bond fund (ticker: BTMSX) and the Baird Core Intermediate Municipal Bond fund (BNMSX)—noted that there is "no doubt" that the credit quality of municipalities has been negatively impacted by Covid-19, "but the data can be misleading, if not overstated."

While state revenues fell 29% on average from March through May, the divergence between states was significant. State tax revenues in Oregon and California fell 53% and 42%, respectively, while those in North Dakota and South Dakota rose 8% and 1%. They also noted that the "negative revenue impact is better than expected," because it didn't reflect the fact that the tax filing deadline was extended. Meanwhile, municipalities have lots of financial levers, including reserves, cutting spending, and refinancing.

McAllister and Fitterer noted that tax-free municipal yields were still higher than comparable Treasuries "at virtually every point along the yield curve."

"We think the better choice for most investors is simply to stay the course if already invested in the municipal market, but to make sure you are within your target risk parameters," the managers wrote. "If not currently invested in municipals, then moving out from cash or even taking some winnings from a rising equity portfolio may also be prudent moves.

“Investing in a liquid, higher-quality fund or portfolio of securities focused on the short-t-
-intermediate segment of the curve remains, in our view, a prudent way to optimize risk and return.”

Barron’s

By Leslie P. Norton

Sept. 3, 2020 12:58 pm ET