Bond Case Briefs

Municipal Finance Law Since 1971

---

3 Reasons Why Muni Bonds Are Still a Good Buy.

What You Need to Know

- Through May 17, the Bloomberg Barclays Municipal Bond Index is up 0.51%, while the Agg is down 2.7%.
- The prospect of higher income taxes on high earners seems to be supporting munis, along with more fiscal stimulus.
- The $1.9 trillion American Rescue Plan provides $350 billion to state, local and tribal governments.

The municipal bond market is having a very good year, and its outperformance will likely continue.

Year-to-date through May 17, the Bloomberg Barclays Municipal Bond Index is up 0.51%.

This may not seem that great, but it far outpaces the performance of the Bloomberg Barclays Aggregate Bond Index, down 2.7% so far in 2021, and the Bloomberg Barclays Investment Grade Bond Index, off 3.55%, according to Cooper Howard, director of fixed income strategy for the Schwab Center for Financial Research.

Howard spoke with ThinkAdvisor Wednesday about the muni market's outperformance and why it could continue despite their recent price gains over Treasuries thanks to trends in three areas.

1. Economic Factors

The Biden administration's $1.9 trillion American Rescue Plan provides $350 billion to state, local and tribal governments to ease the economic impact of the COVID-19 pandemic, although the impact of the pandemic on state and local governments was not as bad as originally expected.

Though many workers, especially in lower-income jobs, lost employment benefits or pay, those with higher incomes were far less affected, according to Howard.

The better-than-expected rollout of COVID-19 vaccines in the U.S. is also supporting state and local economies.

All these developments support the credit quality of municipal bonds. State and local governments haven't had to implement deep spending cuts, and the credit quality of munis has improved, Howard said.

There have been a number of upgrades of muni bonds. Most recently, Moody's Investors Service's upgraded outlook for $38.7 billion worth of New York City general obligation bonds, from negative to stable.

Moody's also affirmed its Aa2 rating for the bonds. S&P revised its issuer outlook to stable across the board in the U.S. public infrastructure sector (including 185 debt ratings for 126 issuers), according to Goldman Sachs.

State and local governments still face fiscal challenges, such as unfunded pension plans, which were apparent well before the pandemic began. The dire forecasts anticipated for municipal debt in March 2020, though, never materialized, according to Howard.

2. Technical Factors

Supply and demand factors are also supportive of the muni bond market.

Demand for munis by mutual funds and ETFs has risen in 51 of the past 53 weeks, said Howard, noting that “strong demand has not kept pace with supply.”

Morningstar reported this week that April fund flows — which include mutual funds and ETFs — marked the 12th consecutive week of inflows, totaling $122 billion, including $11 billion in April, of which $3.5 billion were in high-yield munis.

Municipal fund inflows totaled $42 billion through April 30, marking “a record to start” for a year, according to Goldman Sachs.

“The prospect of higher income taxes along with greater confidence in issuer financial health may be contributing to the strong demand,” according to Morningstar.

Adding to the supply/demand imbalance is the expectation of the usual net negative muni supply in the summer, when principal and coupon payments for many muni bonds come due, prompting funds to reinvest proceeds into other muni bonds.

3. Tax-Related Factors

Higher taxes are another major factor in the growing demand for municipal bonds, whose interest payments are exempt from federal, state and local taxes.

President Joe Biden’s American Families Plan — estimated to cost $1.8 trillion over 10 years to increase funding for education, child tax credits and child and dependent care tax credits — would be funded with higher taxes on wealthy Americans, including a higher marginal income tax rate and higher capital gains tax rate.

“It’s clear the administration wants to raise taxes on higher earners, but there are questions about how high they will go,” Howard said.

Higher marginal tax rates on wealthy investors, who are major investors in municipal debt, would have the bigger impact on municipal bond demand since most muni investors purchase the bonds for income, not capital appreciation.

The White House has proposed raising the minimum marginal income tax rate on individuals earning more than $452,700 and married couples earning more than $509,300 from 37% to 39.6% starting in 2022.

The 39.6% rate was the top marginal income tax rate before it was reduced by the 2017 tax cut plan in the last administration.

ThinkAdvisor

by Bernice Napach

May 18, 2021