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A Look at What's Driving Muni Bonds in 2H 2021.

Municipal bonds have always been an attractive fixed income asset class thanks to their tax-advantaged status and government safety net – especially for investors that fall into higher tax brackets. These benefits have become even more pronounced with potential capital gains tax increases for high earners and rising inflation.

According to Municipal Market Analytics, investors snapped up more than $40 billion worth of muni bonds during the first half of the year, which was the most over the same period since 2008.

Let's look at these trends and three reasons they are poised to continue into the second half of the year.

Stabilizing Quality

Moody's Investors Service raised its outlook for state and local governments to "stable" from "negative" after the $1.9 trillion pandemic relief bill passed in March, saying that the funds would stabilize state finances and help avoid local government funding cuts. The upgrade helped draw many investors back into muni bonds after the sell-off.

State governments have also been able to raise billions of dollars on highly favorable terms in recent months. For example, Illinois saved millions of dollars when it borrowed $1.26 billion in mid-March, paying just 1.09% compared to 3.42% on comparable bonds. These sales have helped increase supply, while refinancing has improved credit ratings.

Rising Interest Rates

Interest rates have been on the rise over the past year. For instance, 10-year Treasury yields have risen from a low of nearly 0.5% during the middle of last year to about 1.75% earlier this year. In addition, annual inflation rates have been running at about 5%, thanks to a nearly 50% increase in lumber prices and a 30% increase in energy prices.

Municipal bonds aren't nearly as sensitive to interest rates as Treasuries or corporate bonds. This is because many investors hold the bonds until maturity, creating stickier prices unless rates truly start to accelerate. The tax-advantaged status of muni bonds also offsets some interest rate risks, as many investors prefer to avoid taxes – even if rates rise.

Taxes & Incentives

The Biden administration's proposed tax changes could make municipal bonds even more attractive to investors. In particular, the president's proposal to hike top capital gains rates to 39.6% could make after-tax muni yields attractive. After all, the after-tax yield of a 5% muni bond is closer to an 8% corporate bond for investors in the 35% tax bracket.

The latest bipartisan infrastructure plans could incentivize municipalities to issue more public-private bonds, private activity bonds and direct-pay bonds on the supply side. While Build America

Bonds have been popular since 2009, there is substantial demand for additional types of bonds that could offer higher interest rates than general obligation issues.

Risks Remain

There are many different types of municipal bonds. Each bond has its issuer, structure, creditworthiness, income potential and other factors that investors must consider. During today's low-yield environment and supply-demand imbalance, investors cannot rely on high-quality municipal bonds to meet income requirements.

High-quality state general obligation bonds may not have a lot of upside in today's environment, which means investors may have to seek out sectors where post-pandemic recoveries still offer the potential for improvements. These higher-yielding opportunities provide more cushion against rising rates but come at potentially greater risk.

The Bottom Line

Municipal bonds have always been an attractive asset class due to their unique tax advantages and government safety net. That said, with rising interest rates, improving credit quality and the prospect of higher taxes, these bonds have become even more attractive in recent months, setting the stage for further outperformance during 2H 2021.

Other trends could continue driving the sector higher beyond 2021. For example, the rise of impact investments has boosted interest in climate and social change muni bonds, from bonds funding K-12 schools in underserved communities to alternative energy investments. These trends could accelerate in 2022 and beyond.

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