[Bond Case Briefs]

Municipal Finance Law Since 1971

[Munis Have Slid This Year as Investors Bail Out. They May Be a Bargain Right Now.]

Municipal bonds have taken a beating this year as investors retreat amid rising interest rates. The market, however, could be poised for a comeback thanks to unusually attractive relative yields and strong balance sheets at state and local governments.

BlackRock and Insight Investment are among those arguing that municipal bonds look attractive compared with other bond markets today. The most obvious reason is that yields on tax-exempt 10-year municipal bonds rival those on Treasuries today, around 2.75%, and were yielding more than them as recently as mid-May. That is unusual because unlike Treasuries, interest income from munis are exempt from federal taxes and sometimes exempt from local tax in the states where they are issued, which is typically reflected in lower yields for munis because investors get to keep more of their interest payments.

Tax-exempt 10-year munis with AAA ratings yielded 98 cents for every dollar of Treasury yield on May 25. That's higher than average over the past decade, when they yielded 94 cents for every dollar of Treasury yield. And excluding the first six months of 2020—when investors were concerned that fallout from Covid-19 would cripple state and local governments—they paid out 91 cents for every dollar of Treasury yields since 2012.

That raises one big question: If munis offer such a good deal, why aren't they more popular?

Investors have pulled a net $38 billion from funds that invest in tax-exempt municipal bonds so far in 2022, according to Refinitiv Lipper, with outflows in 18 of the past 19 weeks, including a net $1 billion withdrawal the week ended May 25. That is the longest stretch of withdrawals since 2013.

It is likely because rising interest rates have fueled a selloff in the market in 2022, with the ICE US Broad Municipal Index posting an 8.2% year-to-date loss as of May 25.

"We've had a selloff and now [individual investors] are selling, even though it's the worst possible time to sell," said Vikram Rai, head of municipal strategy at Citigroup. "If mutual-fund flows stabilize, then muni returns will improve."

In other words, individual investors have been chasing performance—that matters because individuals own a greater share of the muni bond market than other corners of fixed-income markets. And the market's performance looks like it's in the early stages of a turnaround, with a 2.1% return for the week ended May 25.

What's more, the muni-market selloff was driven by volatility in the Treasury market, and not fundamental problems with state and local governments' finances. In fact, states have built up their largest fiscal cushion on record, according to Pew Research Center, after municipal governments received unprecedented support from the federal government's response to the Covid-19 pandemic.

"The fundamental backdrop for munis is incredibly strong," said Sean Carney, head of municipal strategy at BlackRock. “At these levels, these valuations, the market is pricing in a lot of bad news. And there’s not a lot of bad out there once rates begin to stabilize.”

The summer months are usually a good time for municipal bonds, he added, because bond maturities remove supply from the market and interest payments give investors extra cash to reinvest. “Over the next three months…the balance of supply and demand will be much more favorable,” Carney said.

The market also stands to get “crossover buyers”—insurers, foreign investors and banks that don’t benefit as much from munis’ tax exemptions—that are moving into the market with bets that yields may have peaked, investors say.

“Insurance companies, large commercial banks and global investors have not only found value in the taxable muni bond market, but also the tax-exempt market, given their experience of it being a high quality market that produces solid streams of income” said Thomas Casey, senior muni-bond portfolio manager at Insight Investment.

Contrarians who want to take advantage of investors’ shifting appetites can buy muni funds, but they come with a risk: The funds offer daily liquidity, so investor withdrawals may force managers to offload bonds at a loss. Most closed-end muni funds use leverage, meaning they borrow short-term and reinvest that borrowed money in long-term securities, introducing extra risk when short-term interest rates move in unpredictable directions. And while open-ended funds generally don’t use leverage, strategists say investor withdrawals are weighing on the entire market. So in general, investors in muni funds should prepare to see red on their quarterly statements until interest rates start falling or other investors wade back into the market.

Investors who won’t be trading in and out of positions often—a group that should include most individual investors—could instead focus on buying and holding individual bonds in their brokerage accounts.

Investors in high-tax states, such as New York and California, can buy bonds issued locally for a state or even local tax break. The trading costs of muni bonds, known as markups, are notoriously high for individual investors trading bonds. But they have been declining in recent years, according to the Municipal Securities Rulemaking Board—and since 2018 brokerages have been required to report them. In short, markups are a one-time cost that allows an investor to forgo paying fund-manager fees and avoid other risks that come with buying funds.

More individuals may be doing this already. Insight Investment’s Casey said that he follows brokerage activity, and has noticed that while investors are still withdrawing cash from muni mutual funds, they have been buying more bonds directly.

For buyers who aren’t eager to do the extra research to build a portfolio themselves, large asset managers offer separately managed ladder accounts for smaller investors. BlackRock, for example, offers standardized accounts for investors with as little as $125,000 (or $250,000 with slightly more customization). That structure gives investors some of the benefits of a large manager’s credit-research team and relieves them of the burden of research.

Fund managers argue that credit selection will be important if the Federal Reserve causes a recession in its efforts to fight inflation. And they warn that some states’ pension funding may suffer as a result of the steep selloff in financial markets this year, which could add hidden risks to seemingly strong fiscal positions.

But there is another trend that benefits investors who are willing to buy munis directly and hold them to maturity: Municipalities default far less often than companies do. The long-term default rate for municipal bonds is around 0.1%, while the comparable rate for corporate bonds is around 7%, according to Moody's.

The municipalities that did default had an average rating in the lowest tier of investment-grade (BBB-) five years before the event. So investors looking to pick individual bonds may want to stick with bonds rated A or higher, especially if economic growth continues to slow.

Among bonds rated A or higher, fund managers from both BlackRock and Insight Investments said they favor municipal bonds with claims on distinct revenue streams from state and local governments, known as "special revenue bonds." Those can include water and sewer services, toll roads and other utilities and essential services.

If the idea sounds simple, that's because it is—people need water and sewer services, so those borrowers will probably keep paying. That highlights why the muni market is one of the only bond markets where individual investors have a fighting chance of solo investing success, even if they don't necessarily have an edge.

Barron's

By Alexandra Scaggs

May 30, 2022