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With Low Prices and High Yields, Municipal Bonds Are Alluring.

The bad news is that 2022's first half was dreadful for stocks and bonds. The good news isn't just that it's over, but that the massive markdowns present opportunities. That's especially true for municipal bonds, where the plunge in prices has lifted yields to levels competitive with equities'—with much lower risk.

In round terms, yields have roughly doubled on munis, along with those on Treasuries, since the beginning of the year. Moreover, top-grade tax-free long-term munis now yield more than comparable Treasury long bonds. Since the end of 2021, triple-A-rated munis' yields have increased by 177 basis points—each basis point is equal to 1/100th of a percentage point—to 3.26% Thursday, surpassing the 3.12% yield on the 30-year Treasury. That means the long muni was generating 104.5% of the Treasury bond's yield, compared with 78% at the end of 2021. (Yields fell later in the week.)

And among munis just below the top credit tier, spreads—the extra yield premium to compensate for risk—have widened, albeit somewhat less than for corporate bonds. Good-quality munis, rated double-A or single-A, yield close to their corporate counterparts. That makes munis' after-tax yields substantially higher in taxable accounts (that is, other than tax-deferred retirement ones).

To be sure, the price adjustment has been painful for municipal bond investors. The iShares National Muni Bond exchange-traded fund (ticker: MUB) returned a negative 8.20% from the beginning of the year through June 29, according to Morningstar. It's only a small consolation that the iShares Core U.S. Aggregate Bond ETF (AGG), which tracks the U.S. taxable investment-grade bond market, fared worse—it lost 10.56% in the same stretch. Or that stocks suffered much more, with the SPDR S&P 500 ETF (SPY) returning a negative 19.33%.

But the price drops have made munis' valuations compelling. That's especially true for investors in high-tax states, who haven't been able to deduct state and local taxes from their federal tax returns in recent years, observes John Mousseau, chief executive and director of fixed income at Cumberland Advisors, which manages separate accounts using munis.

For investors without state and local income levies, munis yielding 4.25% are the equivalent of taxable bonds yielding about 7%, he says. But for those in high-tax states facing total marginal rates over 50% (including the 3.8% extra levy on investment income mandated under the Affordable Care Act for certain high-income investors), the yield is comparable to about a 9% taxable return. That is competitive with equities when adjusted for munis' lower risk, he adds.

Munis' repricing reflects both the jump in Treasury yields and factors peculiar to the sector, observes John Miller, head of municipals at Nuveen, a major manager of state and local bond funds. That was exacerbated by huge outflows from muni mutual funds, which are approaching $85 billion this year, already topping the previous full-year outflow of about $72 million in 2013, he says. Ironically, this is occurring despite the fundamental improvement in state and local finances resulting from the big jump in tax revenue with the economy's recovery from Covid-driven weakness in 2020.

To illustrate the current opportunities, Miller cites bonds issued to finance the renovation of New York's LaGuardia Airport. When Joe Biden was vice president in 2014, he called LGA a third-world facility, which locals said was unfair to emerging nations' airports. Now, after a multibillion-dollar renovation, the once-despised airport has returned to the top tier (although getting there remains a nightmare).

Uninsured New York State Transportation Development Corporation LaGuardia Airport Terminal B Redevelopment Project Series A bonds (rated at the lower end of the investment-grade bond scale) with a 5.25% coupon were priced to yield 4% if called in 2024 or 5.10% at maturity in 2050. To a New York City resident in the top bracket, the latter is equivalent to a fully taxable 11.49%. (The top 55.6% tax rate on Big Apple denizens making over $25 million annually, along with rising crime, helps explain the exodus to lower-tax locales.) Insured bonds, which get a double-A rating, have a 4% coupon and were priced at 88.75% of face value, for a yield of 4.72% at maturity in 2051.

Another attractive credit also hails from the New York metro area. Mousseau cites the general obligation bonds from Long Beach, a Long Island city that has beaches similar to those in the Hamptons, without the hype. With insurance that provides a double-A rating, he likes its 5.25% bonds, priced at a premium to yield 4.73% at maturity in 2042 and 4.25% if called in eight years. That's equivalent to nearly 9% for the highest-taxed New Yorkers, he notes.

For the more speculative-minded, leveraged closed-end funds offer higher yields but with increased risk.

In addition to the Nuveen Municipal Credit Income Fund (NZF), Miller also points to Nuveen Municipal Credit Opportunities (NMCO), which trades at a small discount to its net asset value, while paying a current tax-free yield of 6.11%.

One calendar wrinkle to consider: Beginning July 1, muni investors receive a wave of cash payments from interest coupons, called bonds, or holdings hitting maturity. That cash must go somewhere and, given the parlous state of the equity market, Mousseu expects most of it to be reinvested in municipals. At the same time, both he and Miller suggest that investors swap depreciated bonds for similar securities to book tax losses, in order to offset gains on other holdings.

With stocks in a bear market, munis look like a good place to ride out the storm.

Barron's

By Randall W. Forsyth

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