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Uncle Sam's Debt Woes Create Opportunity for Muni Buyers.

'If you think taxes are going up, munis and the muni exemption are a great place to be," Nuveen's head of municipals says.

Uncle Sam is digging a hole that only taxpayers can fill. That's why advisors are plugging their high-net-worth clients' portfolios full of tax-free municipal bonds.

The Congressional Budget Office said this week that the federal budget deficit for the first six months of fiscal 2024, ended in March, was $1.064 trillion. For the full year of 2024, the CBO sees the budget deficit totaling $1.5 trillion, a decrease from the $1.7 trillion deficit in 2023 that was the third-largest in American history.

Like it or not, those bills are going to have to be paid. And that means the folks down in Washington will be figuring out ways to hike taxes however and wherever they can, on top of selling new bonds to pay for the old ones.

Since interest income from munis is exempt from federal income tax and munis issued within a client's home state are generally exempt from state and local taxes, muni bonds will increasingly become a haven for the well-heeled as taxes rise. And while the market has seen explosive growth in Treasury and sovereign issuance, the same can't be said on the muni side.

Meanwhile, outside the nation's capital, the country's municipalities are showing strong credit fundamentals, said Dan Close, head of municipals at Nuveen.

"Right now, state and local governments have $290 billion on their balance sheets from five rounds of COVID finance," he said. "They are prepared to take anything that comes our way in an economic downturn."

Close added that the rating agencies have upgraded munis by a factor of 4 to 1 over the past three years. On the other hand, the nation's credit rating is heading in the other direction, with Fitch downgrading the country's long-term credit rating last August to AA+ from AAA.

"If you look at Biden's initial budget, it was taking taxes from 37 to 39.6 percent at the federal level and from 3.8 to 5 percent for the Medicare surcharge," he said. "So if you do think taxes are going up, munis and the muni exemption are a great place to be."

Elsewhere in Washington, over at the Federal Reserve, Close sees a maximum of three rate cuts this year. If and when they arrive, he sees that as a bullish sign for munis, where income levels remain high.

"You're getting paid right now to wait," he said. "On an average portfolio of AA-minus, intermediate duration, you're getting in excess of 6% on a taxable-equivalent yield, and more than 9% for high yield."

Trent Leyda, CEO of SpirePoint Private Client, agrees, saying taxes for high-net-worth individuals can be complicated, therefore tax-free municipal bonds are usually used for higher-tax-bracket taxable accounts.

“The yields tend to be lower than what you can get on high-quality corporate bonds or Treasury bonds,” said Leyda. “However, the tax-equivalent yield is usually at parity with taxable bonds. It is always advisable to understand the credit quality, the interest-rate sensitivity and the underlying corporate health of all bond issues.”

All that said, Tom Graff, chief investment officer at Facet, sees municipal bonds as “extremely expensive” right now compared to taxable bonds.

“A typical 5-year, high-quality muni bond yields about 2.6 percent to 2.7 percent, while the 5-year Treasury yields 4.55 percent,” he said. “If you are in the highest federal tax bracket of 37 percent, the Treasury would yield 2.87% after paying taxes on the income. That’s a bit higher than the tax-free muni yield. If your tax bracket is anything lower than that, munis are an even worse deal.”

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By Gregg Greenberg

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