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The Fed rate hike opens up an opportunity for muni bond investors

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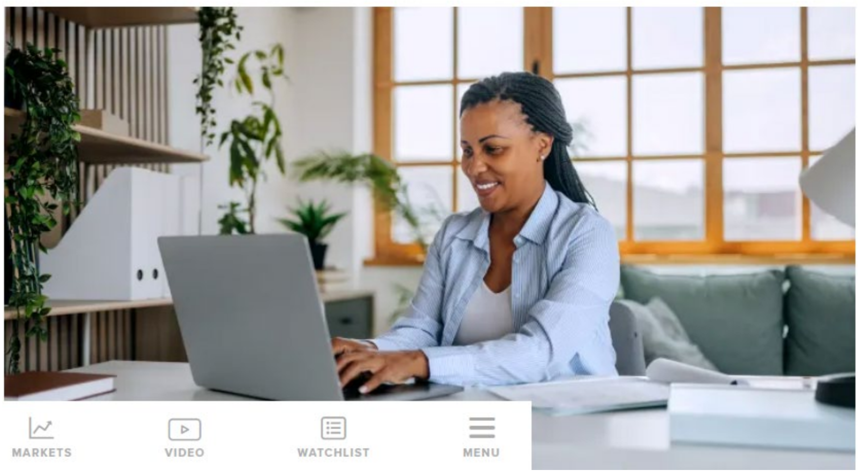

As the [Federal Reserve] pushes interest rates higher, municipal bonds are offering increasingly attractive entry points for investors seeking tax-exempt income.

Like in the Treasury market, muni yields remain high. On Friday, the [10-year Treasury] climbed [to the 5% mark] as investors digested the [latest Fed hike] and the trajectory of its monetary policy. Bond yields move inversely to prices.

The Bloomberg Municipal Bond Index is yielding about 4.3%. However, the income on munis is exempt from federal taxes and, if the holder lives in the state in which the bond is issued, free from local taxes as well. That translates to a tax-equivalent yield of 7.3% for those in the highest tax bracket, said Chris Gunster, head of fixed income at Fidelis Capital.

"You're not going to find that in the Treasury market. You're not going to find that in the corporate bond market," he said. "So we see that as a very attractive place."

The iShares National Muni Bond ETF (MUB) , which tracks the investment-grade market, currently has a 30-day SEC yield of 3.8% and an expense ratio of 0.05%.

Right now, the muni market is awaiting stabilization in the Treasury market, which saw its yield curve flatten sharply this week, Bank of America strategist Yingchen Li said in a note Friday.

"In our view, the Fed's firmer posture plus Treasury buybacks of long bonds should steady the market and put munis on good footing for the long-awaited Fall rally," he said.

The Treasury Department said last week it will buy back up to $6 billion in longer-term debt, which has been seen as an effort to rein in Treasury yields.

Barclays said it is also wading into the municipal market, despite challenging technicals.

"[M]uni ratios have widened, index yields are approaching multi-year highs, and a more assertive Fed should help longer-term rates," Mikhail Foux, head of the firm's municipal research and strategy, said in a Friday note. "Thus investors should gradually add exposure, with a focus on higher-quality names."

Muni ratios refer to the difference in the yields between munis and Treasurys of the same maturities.

However, while yields will remain volatile and could potentially rise from here, this is not a time to be just easing into the market, said Tom Kozlik, head of public policy and municipal strategy at Hilltop Securities.

"I wouldn't just be dipping my toe into the municipal market right now. I'd be jumping in at these levels," he said.

In fact, looking at municipal market data (MMD) AAA-rated yields on long-term bonds over the last 26 years, "there's only a handful of times where yields have even come close to these levels," he said.

The MMD is the benchmark yield curve for AAA munis.

Finding opportunities

Despite the volatility in yields, the muni market's fundamentals remain sound.

"A lot of issuers learned their lessons from Covid and from the GFC [global financial crisis]," said Nathan Will, head of municipal credit research at Vanguard. "[They] have very strong reserves and have learned how to manage revenues and expenditures, knowing that money from the pandemic has run out and they also have infrastructure needs."

Bank of America likes high-quality issuers, specifically AAA-rated bonds. It finds the entire curve attractive, but said the long end offers the best potential for outperformance.

"The 10yr AAA spot should lead any sustainable reversal, with 2s10s AAA flattening beginning now after months of steepening," Li said. "The timing is helpful:

September MTD issuance of roughly $37bn is 50% higher y/y, with new money up 74%, giving investors far more bonds to choose from."

Kozlik said he is most enthusiastic about longer-maturity bonds, targeting those between 20 and 30 years. However, investors should be aware of interest rate risk, since it rises the longer you go out on the curve.

"Municipal yields have risen faster than Treasurys, and so relative value and relative value indicators are more attractive than they were, especially relative value indicators like in the 20-year maturity and out," he said.

Fidelis Capital's Gunster believes investors can look in both the investment-grade and high-yield markets, depending on their risk tolerance.

Within high yield, he likes to use funds that have an active manager and a broadly diversified portfolio, which can mitigate risk.

There are a number of high-yield muni exchange-traded funds on the market that are actively managed, including the iShares High Yield Muni Active ETF (HIMU), which has a 5.31% 30-day SEC yield and 0.4% expense ratio, and the Nuveen High Yield Municipal Income ETF (NHYM), which has a 30-day SEC yield of 4.95% and a 0.35% expense ratio.

Within investment-grade assets, Gunster does his own active management and stays with high-quality A-rated bonds and better. He also avoids troubled areas like secondary schools and smaller universities and colleges.

Gunster also looks for opportunities for tax-loss harvesting, which involves selling assets at a loss to offset realized gains in an effort to lower taxes.

“We can sell one bond at a loss and purchase another bond, and thereby handing the client a tax benefit, a loss that can be applied to other portions of the portfolio,” he said. “You’re simply swapping one 5% bond with another 5% bond, and you carry on.”

“If the market gives you this opportunity, you take it,” Gunster said.