Investment Insights

Expensive Municipal Bonds Create Opportunities to Improve Yield and Credit Quality

John Mitchell
Municipal Bond Credit Analyst

Highlights

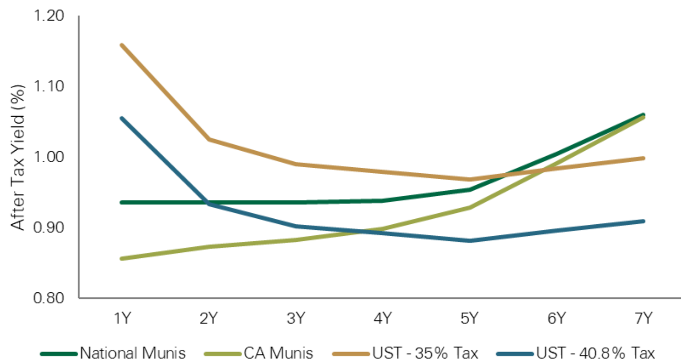
- Recent supply and demand trends have left municipal bonds relatively less attractive versus taxable Treasury securities
- For appropriate accounts, Bessemer will tactically consider holding more taxable bonds, always aiming to get the best after-tax, risk-adjusted returns
- We would underline that despite low and falling yields across bond markets, we continue to find total return potential attractive for this defensive asset class, including versus holding cash

A confluence of market and policy factors has caused short-term municipal bonds to become extremely rich, or low-yielding relative to U.S. Treasury securities. The municipal department at Bessemer constructs portfolios, for individuals and our bond funds, intended to provide attractive risk- and tax-adjusted returns. As we continue to execute on that mandate, more Treasuries may be seen in portfolios, at least on a tactical basis, because in many situations they offer superior relative value.

Technical factors have helped drive this unusual relationship. In terms of demand, the municipal market has seen relentless flows into bond funds this year. Despite there being more than four months left in the year, investors have allocated more new money to municipal bond funds in 2019 than in all but a couple of full years on record. On the supply side, new borrowing has fallen approximately 10% short of expectations for the year. This issuance miss, combined with high levels of calls and maturities, has resulted in the outstanding supply of municipal bonds being about $30 billion lower than at the start of the year. In addition, tax reform eliminated much of municipalities' ability to refinance debt by bringing new, lower yielding bond issues to market, removing an important source of high-grade paper.

This environment is uncommon. Municipal yields versus Treasuries ended July at their lowest levels in more than 15 years. While municipal bonds have become slightly more attractive since hitting that historic level, Treasury bonds often offer an increase in after-tax yield versus many high-grade municipals for a number of buyer classes. In many instances, Treasuries provide after-tax yield pickup regardless of tax bracket or state residence inside of two years, in part due to the recent inversion of the Treasury yield curve (Exhibit 1). In high-tax states with suppressed in-state yields or those not subject to the highest marginal tax rate, Treasuries offer yield pickup even extending out on the maturity curve. While capital gains taxes can make it uneconomic to capture this dynamic through selling existing holdings, we look closely at individual tax situations in deciding whether to switch into new bonds with higher after-tax yields. In doing so, portfolios can transition toward higher credit quality and better liquidity with equal or better after-tax yields.

Exhibit 1: After Tax Yields



As of August 14, 2019.
Source: Bloomberg

Turning to the predicament that investors face in a low bond yield environment, whatever the type of bond we are considering, one common question is the tradeoff between bonds and cash. Even with nominal Treasury yields below 2%, bonds still have the potential to generate attractive returns and outperform cash in the coming quarters. In addition to a bond's yield, there are two other components of return: "roll" and price gains. Roll, or "roll-down," is prominent when the yield curve is positively sloped, with cash yields lower than those of bonds. Since the curve is inverted, this component of return is negligible.

The larger component of return comes from the fact that when yields fall, bond prices rise. This is why a bond portfolio's total return can vastly overshadow its yield. Longer-term bonds' prices rise by more than shorter-term bonds' prices when yields fall. For example, if yields were to decline another 1% (or 100 basis points, in bond lingo), a 10-year Treasury note's price would rise about 9.2%, a 2-year note's price would rise only about 1.9%, and cash would experience no price change (Exhibit 2). Investors in short-term, lower return instruments then face the prospect of having to redeploy their capital in a lower rate environment, extending the underperformance. This is why we hold longer-term bonds — even when their yields are lower than cash deposits — in our clients' portfolios. Our aim is to construct bond portfolios that provide our clients with attractive, safe after-tax total returns over the long term.

Exhibit 2: Hypothetical One-Year Return Profile Following a 100 Basis Point Decline in Rates

	Cash	2-Year Treasury	10-Year Treasury
Yield	2.3%	1.6%	1.6%
Price Change	0.0%	1.9%	9.2%
Total Return	2.3%	3.5%	10.8%

As of August 16, 2019.
Source: Bessemer Trust

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