Muni Bonds' Electile Dysfunctions

RealMoney readers, when invited to stay interactive, often do. A specific request came in to update a March 2004 column on municipal bonds. My first reaction on reviewing that column was, "oops." I said:

> *First, I will go out on a limb here and forecast that regardless of who wins the White House in November effective marginal tax rates will rise.*

Well, statutory rates did not rise, but a number of state tax rates and the effective federal marginal rates did. Anyone who has been faced with the alternative minimum tax and the various phaseouts of personal exemptions and Schedule A deductions can attest thereto.

And do not – do not! – get me started on the various income ceilings on various tax programs ranging from Roth IRAs to tuition exemptions and beyond. Equal protection under the laws is a wonderful concept for egalitarians unless they can spot a juicy target. Then, in homage to Orwell, some become less equal than others.

Muni Bond Outperformance

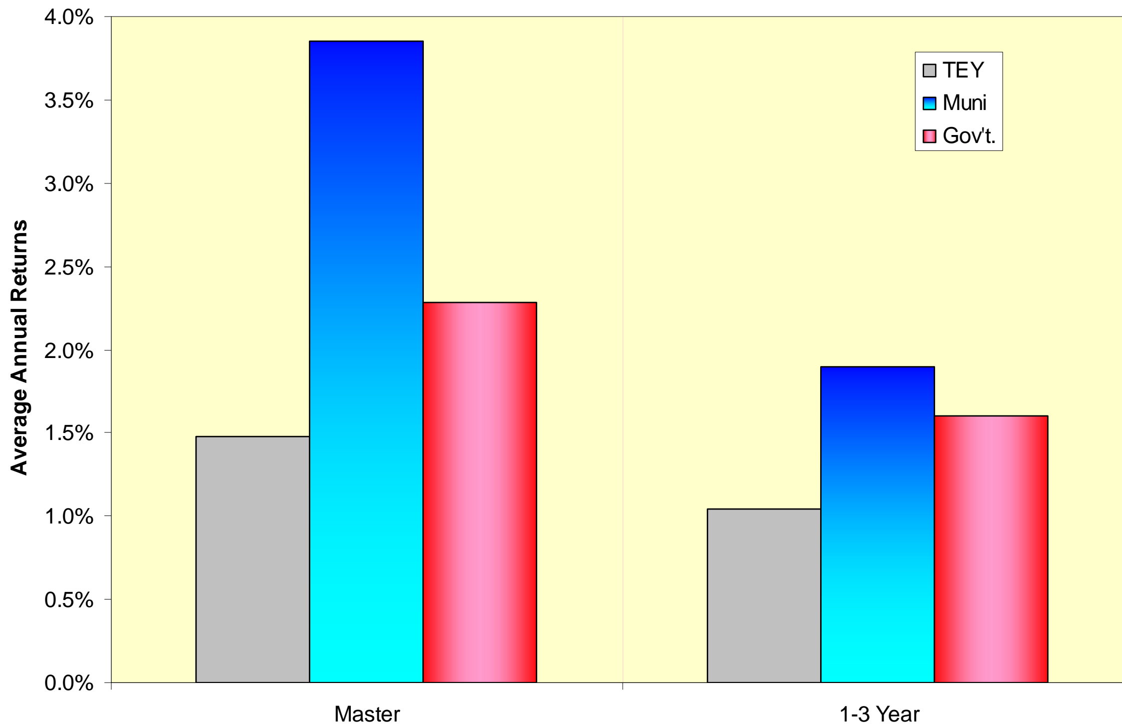
The other factors noted were assessed correctly on their face:

> *Second, just as municipal borrowers benefited from the general decline in interest rates, they will get a free ride higher on local property taxes. One of the cruelties of home ownership is that your replacement cost, the next piece of property you may wish to purchase, is rising in price at a more or less equal rate to your current abode. Realtors and tax collectors can capture these gains, the capitalization of lower interest rates, far more effectively than can the homeowner.*

I cannot speak for your local taxing authority, but right here in Cook County, Illinois, they are engaged in a bit of sanctimonious kabuki theatre on lowering the property tax rates to compensate for the jump in property values. Expecting politicians voting to keep their hands out of your wallet is a little like expecting foxes to vote themselves out of the henhouse. Foxes don't do that.

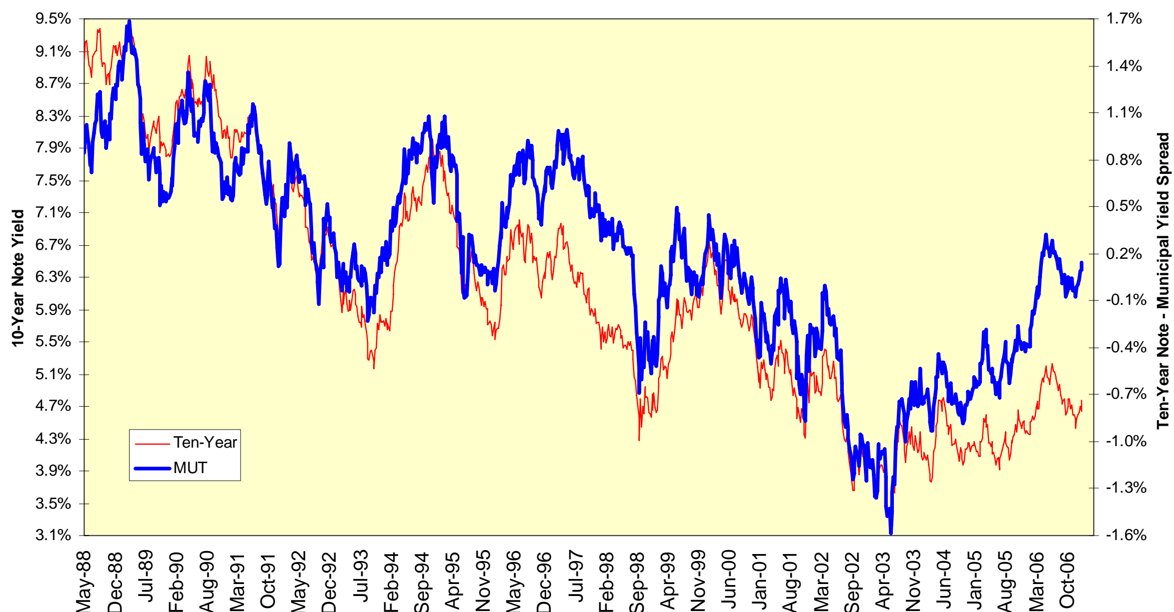
Finally, how did the concluding recommendation to adopt "a strategy of being long municipals relative to Treasuries, with the trade concentrated in short-dated, investment-grade municipals" fare? Let's compare the average annual returns of 3-5 year investment-grade munis and a broad muni bond index to those of their Treasury counterparts. The chart below has three columns, the pre-tax yields for both munis and governments, and the tax-equivalent yield that would have made the muni bonds equivalent to the government bonds after taxes.

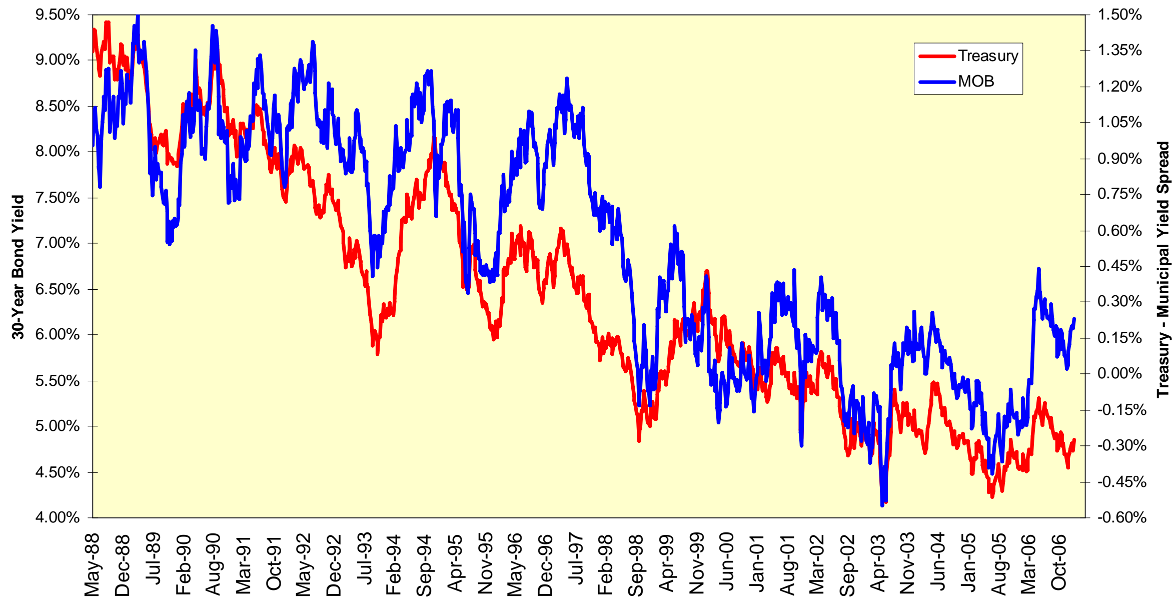
The munis outperformed the governments at both maturity levels, and greater exceeded the tax-equivalent breakeven level. Not bad for government work.



Of MUT And MOB Spreads

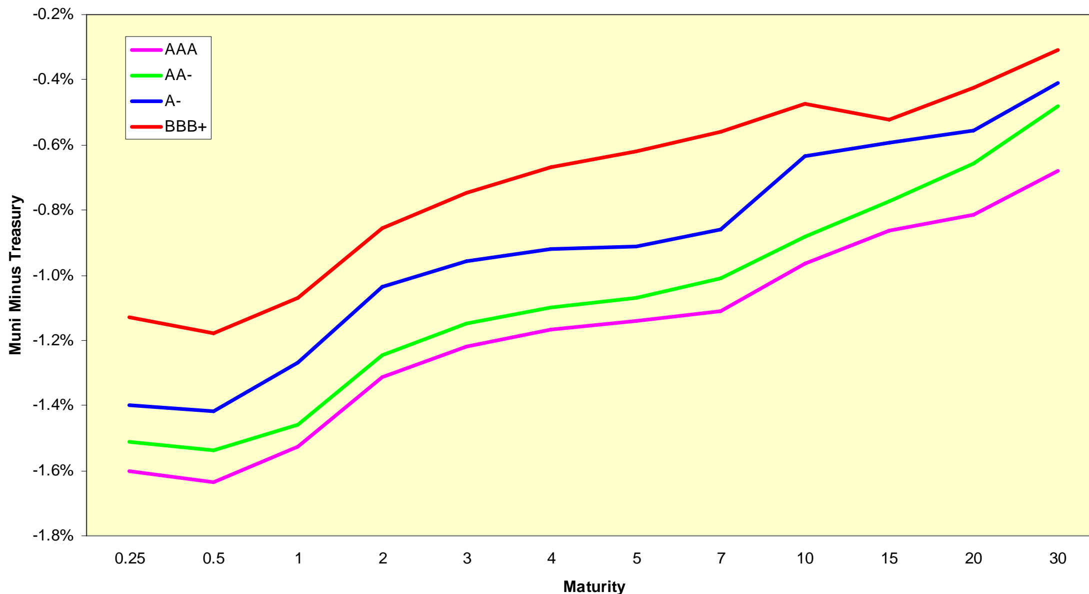
Credit spreads, which have been tightening in both the corporate and emerging market arenas, have been narrowing in the muni world, too. The municipal-under-ten year (MUT) and municipal-over-bond (MOB) spreads, both charted below, have been moving erratically higher since 2004; this is equivalent to saying municipal investors are willing to accept a lower yield in return for a tax-advantage. Of course, actual muni credit quality may have turned higher due to a stronger economy and higher property tax receipts, and the impact of credit default swaps on the market may be masking any and all credit changes formerly encapsulated in the spread, but no matter: Munis became more attractive and the returns show it.





Maturity And Quality….

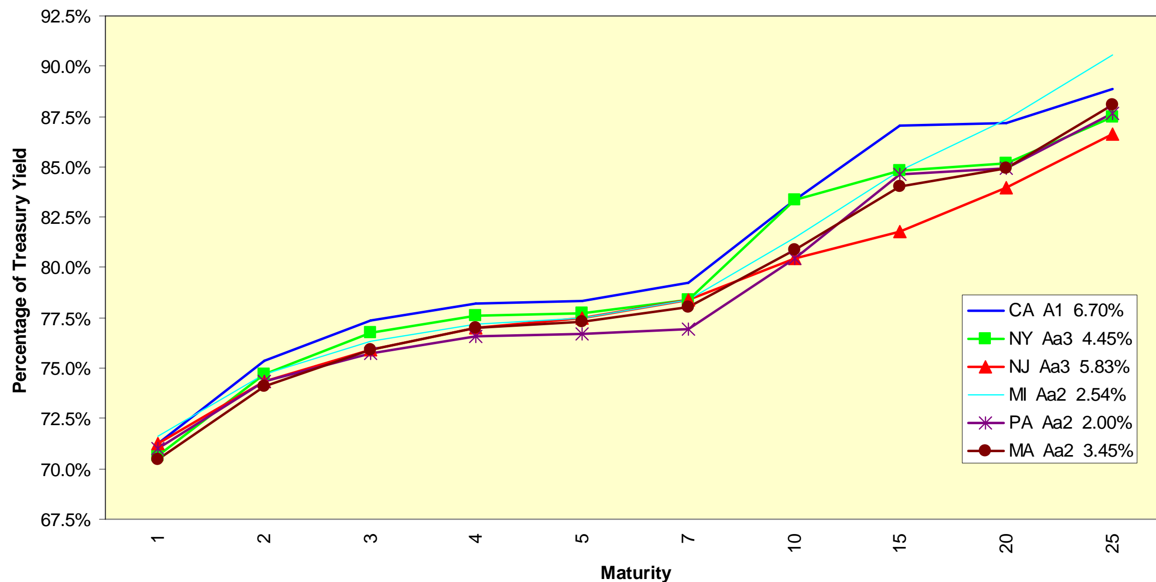
…Should be more than pleas from the lonely hearts on a computer dating service. If we map the spreads between munis and Treasuries by credit rating and maturity, we find municipal yield curves are far more positively sloped than is the Treasury yield curve. Investors do demand compensation for the risks of holding long-term municipals – what, you know what tax rates and a given local government's finances are going to look like 20 years from now? – and these positive curves are somewhat independent of credit rating. If anything, the highest-quality muni bonds have the steepest yield curves and by implication the most risk to their future credit quality.



States Of The Union

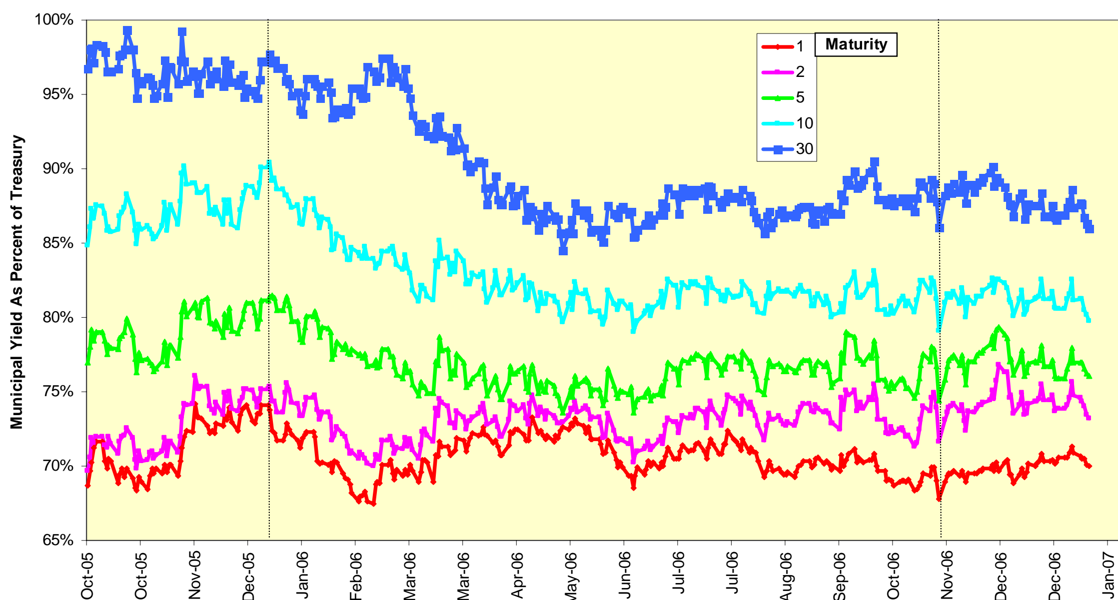
If we look at individual states' general obligation bonds expressed as a percentage of the Treasury yield, we find investors do get compensated for both credit risk and tax policy risk. If we add the nominal marginal federal rate (subject to the outrages expressed earlier) of 35% to a state's marginal tax rate, and subtract the total from 1.00, we get that state's tax-equivalent yield. Let's say you live in New Jersey, the Garden State that sure smells like it, where you face a 40.83% tax rate at the margin. Your tax-equivalent rate should be (1 - .35 - .0583), or 59.17%. Yet you get paid more than this for a series of reasons discussed here in [January 2003](). This is true for other states as

well; the chart below presents five large states' general obligation spreads along with their Moody's rating and marginal tax rates.



The 2006 Election

If muni investors expect higher tax rates, they should be willing to accept lower yields. This started to happen at the end of December 2005 (first dotted line), and the process was largely complete by May 2006. Even though the Senate was expected to remain in Republic control by most, the market priced higher tax yields from the 110th Congress into its yield structure six months ahead of time. Revenue bills originate in the House, and it was clear months in advance the House would be changing hands. After May, the market barely budged; only on Friday, November 3, 2006 did yield spreads change dramatically (second dotted line).



Interestingly, those yield spreads are now turning lower once again. The Democrats' talk of tax-cut revocation at higher income levels is being taken seriously, and the last thing anyone really expects to see going forward is lower taxation. Whatever surge emerges from Washington, D.C., you can bet on a tax surge.

Given the ongoing weakness in residential real estate and a limited capacity for credit quality to improve significantly, take the present action in municipal bond spreads as a warning: The market has acted. There is no reason to abandon any muni allocation you may have, but it is unlikely muni bonds will outperform in the foreseeable future.