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Where to Put Your Muni-Bond Money Now

Higher-quality longer-term munis could be hit by central bank moves, but there are other places where returns are safer.

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By AMEY STONE
 Sept. 17, 2016 2:40 a.m. ET

Municipal-bond investors have enjoyed a smooth ride to slow and steady gains for the past year. But that ride has gotten bumpy lately—and is likely to get rockier still.

Investors are worried that central banks are going to shift to less bond-friendly policies. Treasury yields, which move inversely to prices, have risen, as have muni yields. The yield on the 10-year triple-A muni index, at 1.3% in July, is now nearly 1.6%.

That's not a big increase, but it's enough to produce a negative return on high-quality longer-term munis, says Jim Kochan, chief fixed-income strategist at [Wells Fargo Funds](#). He thinks muni yields could climb to 2% in the next 12 months, putting more pressure on prices.



Photo: Pixabay

This week could be rough. Not only is the Federal Reserve meeting on Wednesday, but so is the [Bank of Japan](#). While the Fed isn't expected to raise short-term rates at that meeting, Japan's rate policy remains a wild card, and any announcement perceived as negative for bonds could spark a deeper selloff in munis.

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Japan the likely source of the volatility. "I wouldn't overreact to it," he says. It would allow people to reinvest at slightly higher rates—which many investors would embrace, he notes.

Still, long-term credit risks remain. Pension shortfalls continue to garner more attention from rating agencies, and political gridlock is worsening budget woes in some areas, like Illinois. Moody's Investors Service currently has negative outlooks on 10 states—Illinois, New Jersey, and Oklahoma among them. Several states, including North Dakota and Alaska, look weaker due to lower energy prices. Pension funding isn't a near-term problem, but in a sharp stock-market correction, it could become one, says Jim Robinson, founder of Robinson Capital.

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Other favorable muni-market dynamics could reverse. The asset class continues to benefit from fund inflows, but that could change when investors start to see negative returns on their quarterly statements, says Kochan. This season is also bringing a flood of new supply, which

isn't necessarily a bad thing for the market, but it could contribute to a downturn if demand retreats.

Such background risks are worth watching, but ditching munis now would be premature. "I don't believe the selloff is sustainable," says Vikram Rai, head of Citi Research's municipal strategy group. He thinks the market overreacts to news ahead of a Fed meeting, and afterward, "things will calm down," he says.

Longer-term munis with lower credit ratings are now "cautious buys," says Rai. He says long-term rates could decline from here—even if the Fed hikes. (That's what has happened in the past.) And he notes bonds from states that may get downgraded are trading at yields that are compelling in light of the overall low-rate environment.

Miller, who manages the Nuveen High Yield Municipal Bond fund, likes Chicago general-obligation bonds. As the city's finances have improved, the bonds are up 14% in the past year, outperforming both the broad muni and high-yield muni indexes. "Credit concerns have not been driving the municipal market at all," says Miller.

Kathy Jones, chief fixed income strategist at Charles Schwab, prefers general obligation bonds over revenue bonds, which are backed by specific revenue streams, such as toll roads. Due to concerns about state finances, many muni investors have gravitated to revenue bonds, driving down their yields. She is an advocate for sticking with quality. Yields of high-quality munis are still higher than those of Treasuries on a tax-equivalent basis for investors in a high bracket, Jones says. Plus, owning quality is always a good defensive move when volatility is on the upswing.

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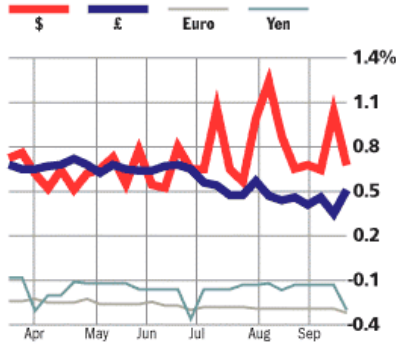


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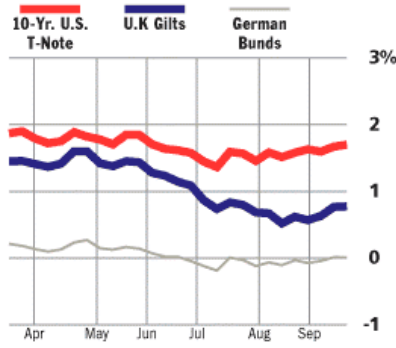
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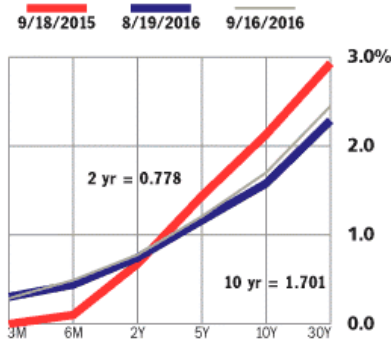
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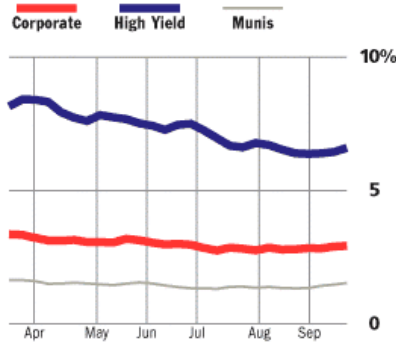
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