CURRENT YIELD

Municipal Bonds Are Hot, but Credit Risks Loom

With Illinois verging on junk-bond status, muni investors would be wise to reduce their exposure.

By AMEY STONE
June 10, 2017

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Municipal bonds have been standout performers lately, besting both Treasuries and corporate bonds so far this year with a 4.13% tax-free return. But those gains have come as storm clouds in the form of worsening credit conditions have gathered in some states.

The darkest cloud yet is now hovering over the state of Illinois. Its general-obligation bonds were downgraded to one notch above junk after its legislature adjourned without passing a budget on June 1. S&P Global Ratings warned that the state could face a "negative credit spiral" and indicated it would lower the rating again if there was no budget agreement by July 1.

If Illinois does get a junk rating, its prices would likely fall more and its yields would rise; its long-term bonds now yield more than 5% (or 8% on a tax-equivalent basis). Some buyers were starting to snap them up Friday, but it's still possible the budget crisis could be resolved. That, however, would take political resolve and the willingness to raise taxes, which many investors are skeptical will materialize.

Even though the state could fix its problems, it has shown little will to do so, says Hugh McGuirk, who oversees municipal-bond investing at T. Rowe Price. "Now the market's patience with Illinois is wearing thin," he notes. Although states can't go bankrupt, Rob Waas, CEO of RSW Investments, thinks there is about a 50% chance the state may miss an interest payment in the next few years.

Underfunded pensions are the main challenge Illinois budgets face, and it is far from alone in that. Connecticut, New Jersey, and Kentucky also have pension plans funded at less than 50%. Credit-rating agencies are paying more attention to these liabilities. With Illinois nearing junk status, "we will likely see a more intense spotlight on other states that have fiscal challenges," says Dan Heckman, fixed-income strategist at U.S. Bank Wealth Management. Late Friday, S&P lowered Massachusetts' ratings due to its failure to rebuild reserves.

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Other headwinds are even stronger: Tax revenues are lower than expected in many states as wage gains have been weaker than forecast, notes Wells Fargo Securities senior municipal analyst Natalie Cohen.

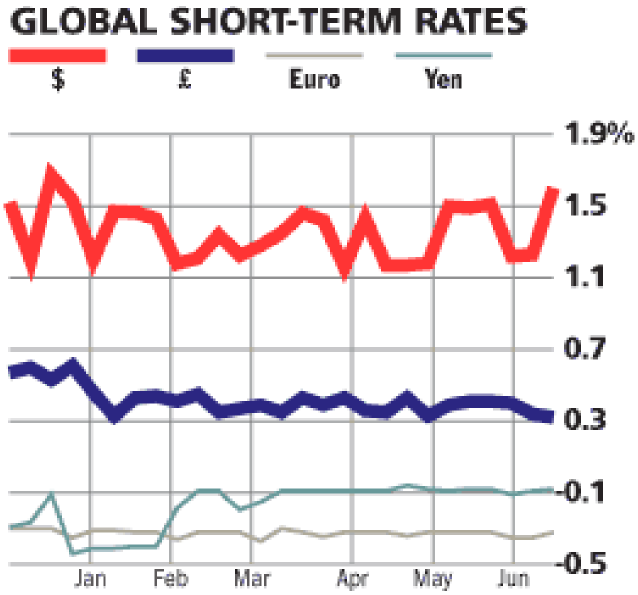
And other bleak headlines have popped up. Puerto Rico entered its own form of bankruptcy in May. Dallas County Schools became the first municipal issuer to default in two years this month, since Dowling College in 2015. Moody's sees the higher-education muni market as increasingly bifurcated between haves and have-nots.

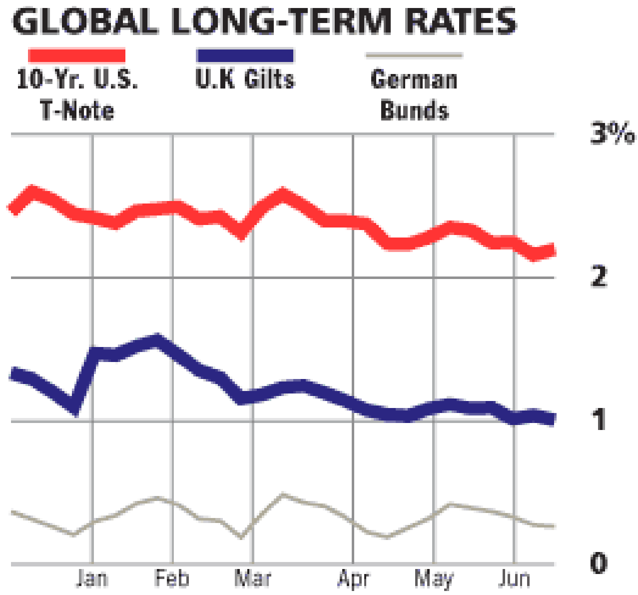
ONE SILVER LINING is that supply and demand for munis is expected to be way out of whack this summer, as issuance falls at the same time many investors seek to reinvest their interest payments and maturing bonds. That gives investors a window to move up in credit quality. "This is a great opportunity to selectively take some profits and at the same time upgrade your overall portfolio," says Heckman.

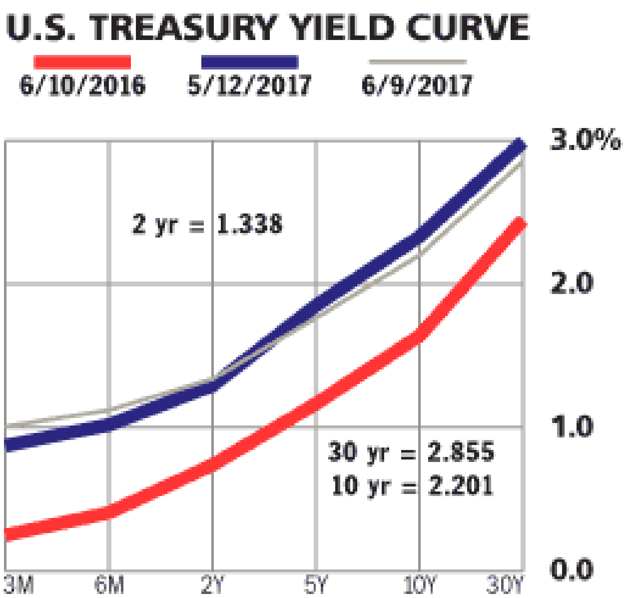
Rick Daskin of RSD Advisors says diversification is key. He isn't recommending closed-end funds with a rate hike looming, but he likes the VanEck Vectors High-Yield Municipal Index exchange-traded fund (ticker: HYD) for its 3.8% tax-free yield. He notes it holds a healthy chunk of investment-grade bonds.

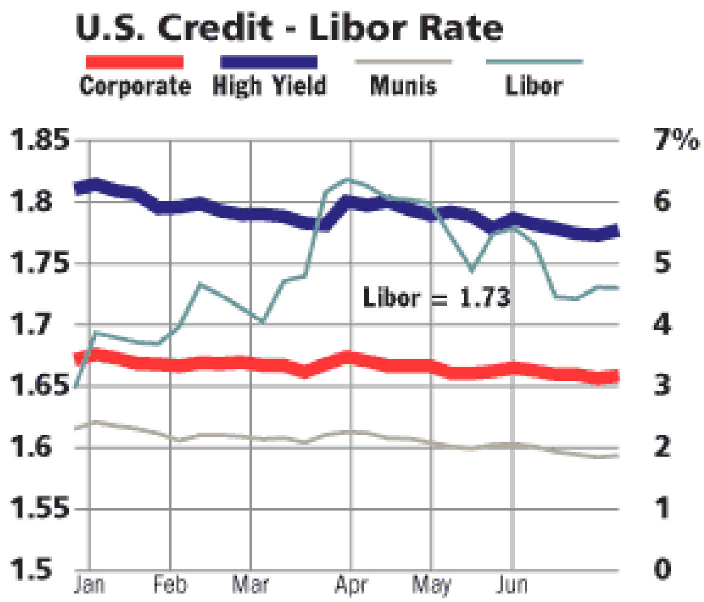
Some closed-end funds still offer value. The top pick of Robinson Capital's Jim Robinson is Eaton Vance Municipal Bond Fund II (EIV), which has a 4.6% yield and trades at a 9% discount. It has a shorter duration than the average closed-end muni fund, which gives it less interest-rate risk.

James Kochan, chief fixed-income strategist at Wells Fargo Funds, recommends investors shorten duration as the Federal Reserve will likely hike rates this week. As well as munis have done this year, "this is not a time to chase rallies," he says.









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