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American National Bank & Trust™

Making Lemonade Out of Lemons

March 6, 2019

Are you subject to one of the higher marginal tax brackets and do you think congress will raise tax rates in the future? If you answered "yes" to either question then you may want to consider municipal bonds for your portfolio.

Listening to the new Democrats in Congress and those running for president, you may have gotten the impression that they would consider raising taxes on the wealthy in order to reduce income inequality. So for the foreseeable future, tax rates probably have moved as low as they are going to go.

What makes municipal bonds attractive in a scenario of increasing taxes is that the interest paid on a municipal bond is exempt from federal income taxes. The higher the tax bracket, the better the tax equivalent yield. If we look back just a few years, we can see why municipals might outperform other fixed income securities. When Bill Clinton was elected president, the top marginal rate was increased and when Barack Obama was in office the expiration of previous tax cuts. In each situation municipal bonds had a period of outperformance relative to Treasury and agency bonds.

In addition, the supply of municipal bonds has been declining. For the last few years the total amount of new issue municipals has been significantly less than the municipals that were called, refunded or matured in a given year. As an owner of any asset, reduced supply and greater demand is a good combination for most investors. This is likely to continue in 2019 and should provide a powerful tailwind for municipal bond performance.

Generally, municipal bonds are an attractive asset class because they normally have higher asset quality and provide consistent levels of income over time. We prefer the credit quality of general obligation, certificates of obligation, high quality revenue or essential service municipals and have avoided hospitals, airports, leases, special purpose municipal credits or anything that might be subject to the alternative minimum tax (AMT).

Consider Wichita Falls Water & Sewer Revenue bonds as an example. Wichita Falls, TX went through two severe droughts in recent history. The city leaders had to take extreme measures to reduce water usage such as limiting the amount of water used to water yards and restricting the washing of vehicles. Yet, the city had to make their debt service on the water and sewer bonds so they raised the water rates. Fortunately, Wichita Falls did not run out of water and when the rains came ending the drought the city did not roll back the prior increases. Not a good deal for water consumers but a great deal for the bondholders.

Finally, municipal bonds also provide negative correlation to a portfolio of equities. In 2018, the S&P 500 declined 4.4% while the S&P Municipal bond index posted a gain of 1.36%. Municipal bonds can provide an important counter balance to an equity portfolio in a volatile market environment such as the one we experienced in 2018.

Not every portfolio can benefit from a municipal bonds' tax-free structure, but if yours can, they can be a great addition to your fixed income allocation. Let us know if you have an interest in discussing the benefits of municipal bonds -- we can review how we would construct a diversified portfolio that would benefit your portfolio now and in the future.