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Rising Supply Creates A Muni-Bond Moment

BY PAULO TREVISANI

A steady increase in municipal- bond supply, coupled with the survival of their tax benefit in President Trump's spending bill, is making the securities more attractive, even as key sectors such as healthcare and education stand to lose.

Municipal-bond investors are in a sweet spot.

Note

Prices have come down, due mainly to historically high issuance, and that pushes up the interest the securities pay. For most of this year, markets worried that the One Big Beautiful Bill Act would curtail munis' tax-exemption benefit, but intense lobbying managed to keep that from happening.

increase in supply
BBB all good

The combination represents an opportunity for investors to add some of the safest fixed-income securities to their portfolios while expecting unusually high, tax-free returns.

What is unclear is how long this will last.

"There's a lot of reasons to be excited about munis" at the moment, said Jason Appleson, head of the municipal-bond team at PGIM Fixed Income.

"A window of opportunity is open, valuations are cheap," Appleson said, while warning, "We are seeing the first signs of normalization…and when normalization occurs, that's when the trade disappears."

High-quality munis yielded as much as 4.74% in April, by the ICE U.S. Muni AAA 30year gauge. They are now at 4.56%, still high by historical standards. The 200-day moving average is 4.14%. The higher-than-average yield means bond prices are lower than usual.

A flood of new bonds could explain it.

Issuance last year hit a historic high of $513.6 billion, according to the Securities Industry and Financial Markets Association. This year is running even hotter. As of July,

issuance was 18% faster than a year earlier, Sifma said.

Weekly flows into municipal- bond funds have decreased since April, but remained mostly positive through July, indicating somewhat steady demand, according to LSEG data.

Note

Experts believe issuance ballooned in great part out of fear that lawmakers would reduce the municipal bonds' tax exemption in order to open room in the budget for Trump's tax cuts and other spending.

With that risk in the rearview mirror and given that interest- rate cuts by the Federal Reserve are likely imminent, the window to secure fat returns could be closing.

"As long as you're willing to not stay short and go out a little bit longer maturity-wise, now is the time to lock in these higher rates," said Jennifer Johnston, director of municipal-bond research at Franklin Templeton.

There are some sectors and jurisdictions that are likely to be hurt by provisions included in the spending bill.

States are expected to shoulder a larger share of education and healthcare costs, straining local budgets.

"As the feds pull back on education, or funding scientific research, or supporting healthcare, it falls to the states" to fill the gap, said Matt Fabian, a partner at Municipal Market Analytics.

That could support relatively high yields while threatening issuers' credit profile.

Fabian said that, though counterintuitive, it may be easier for high-tax states to raise their taxes even higher than for lower-tax states to increase their rates.

Residents there "are comfortable paying higher taxes," he said.

Hospitals top the list of potential victims of the new legislation, and this is a sector that some portfolio managers want to avoid. Many hospitals get most of their revenues from Medicaid and now face budget pressures as funds for the federal program are cut, analysts say.

"It's a negative for hospitals that rely on Medicaid-dol--lar spending," said Shannon Rinehart, senior municipalportfolio manager at Columbia Threadneedle Investments. The hit will be harder in rural areas, where "hospitals are already struggling," Rinehart said. Education is also expected to suffer from a reduction in federal transfers.

But that goes beyond the Big Beautiful Bill and includes Trump's attacks on colleges that the administration deems misaligned with its policies.

"If we could get the education headlines out of the front page of the paper every day, that I think would be constructive to our market," Rinehart said.

Another, wonkier tailwind for munis, Appleson of PGIM Fixed Income said, is the steepness of the yield curve—referring to how much higher longer-term yields are relative to shorter-term ones. He said the curve for munis is steepening faster than that for Treasurys. That means investors willing to trade bonds before maturity can expect a beefy profit.

"So not only did I get my 5% coupon here, I also got an extra dollar's worth on my bond," he said.

4.56%

Yield on high-quality munis, well above the 200-day moving average of 4.14%