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Three Reasons for Muni Bulls to Worry as Values Hit Record High

- Sales may pick up, and tax hit may not be so bad, analyst says
- Stock gains may also trigger a retreat from the safe haven

By Claire Ballentine

(Bloomberg) -- A municipal-bond buying spree, fueled by the state and local tax-deduction cap that's increased tax bills, has pushed some securities to their priciest levels in at least two decades. Demand has outpaced new issuance, with investors adding hundreds of millions of dollars to mutual funds each week. And the Federal Reserve's decision to pause its interest-rate hikes has eliminated a big risk to bond markets.

Analysts from both Bank of America Corp. and Citigroup Inc., the biggest muni-bond underwriters, think there's still room for gains. But Ramirez & Co., a New York-based brokerage, warned customers that there are three factors that could cause a retreat.

New Issuance

One thing propping up the market has been the pace of new bond sales, which slowed sharply last year and has been lackluster so far this year. Peter Block, managing director at Ramirez, said he expects issuance to pick up after the Federal Reserve meeting Wednesday. Even though the Fed has signaled a pause on interest-rate increases, he said issuers are waiting to hear Chairman Jerome Powell's comments before pricing deals. "Most major players in the market have pipelines of deals lined up waiting to go this year," Block said. "Things are going to happen on the new money front."

Stock Rally

Munis have been a "holding place" for investors seeking refuge from the volatility in the equities market, Block said. But stocks have rebounded from their late 2018 drop, with the S&P 500 Index up more than 13 percent this year. If the stock market continues to do well, less money may enter the muni market, allowing state and local debt to cheapen.

Tax Season's End

Block said that after tax season, some may find the impact from the cap on SALT deductions didn't hurt as much as they feared, giving them less incentive to buy municipal bonds to reduce their taxable income. In addition to reducing SALT deductions, President Donald Trump's 2017 tax overhaul also sharply raised the threshold for the Alternative Minimum Tax, a category that helps keep the highest earners from using deductions to decrease their tax liabilities too much. For some, paying less in AMT may have balanced out the pain from the SALT cap, Block said.

Still, they may not know that yet. "Most people don't file their taxes until like two days before" the April 15 deadline, Block said.

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