



Muni Bonds on Sale

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The most interesting quirk in investor behavior is the tendency to sell when an investment goes down and buy when it's going up. A case in point right now is municipal bonds.

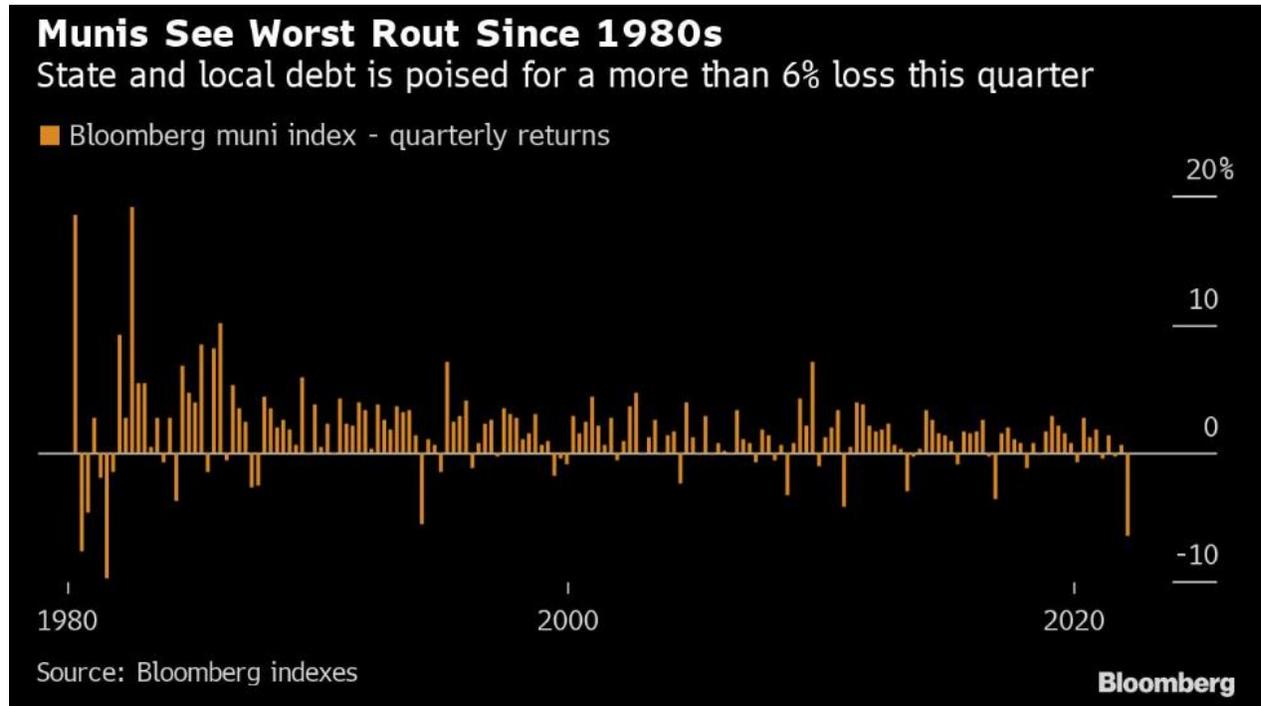
By any measure, Muni bond investments have experienced a terrible first quarter, 2022—in aggregate down 6.4%. That wouldn't be a dramatic decline for risk assets like stocks, but for usually stable Munis, the quarter ranks as a disaster. The culprit, of course, was rising interest rates; bonds issued at lower rates in the past suddenly became proportionately less valuable.

Municipal bonds can be especially interesting for people who are stuck in a high federal tax rate, because most of the bonds deliver income that entirely escapes federal taxes, and if they invest in bonds issued in their state, the income isn't taxed at the state level either. Investors calculate the 'tax-equivalent yield;' that is, the yield that they would have to receive from taxable corporate bonds in order to come to the same after-tax income. For a person who pays federal taxes at a 37% rate, the tax-equivalent yield of a Muni paying 4% would be 6.92%. You can see from the chart that this comparison can be complicated, since it involves different states and different tax brackets, but the basic concept is easily illustrated.

Tax Rate	Taxable Income Bracket	Tax-Exempt Illinois Housing AAA 3.30% due 2032	
		Tax-Exempt Yield	Tax-Equivalent Yield
10%	\$0 to \$19,900	3.30%	3.66%
12%	\$19,901 to \$81,050	3.30%	3.75%
22%	\$81,051 to \$172,750	3.30%	4.23%
24%	\$172,751 to \$329,850	3.30%	4.34%
32%	\$329,851 to \$418,850	3.30%	4.85%
35%	\$418,851 to \$628,300	3.30%	5.07%
37%	\$628,301 or more	3.30%	5.23%
40.8%	Includes NIIT 3.8%	3.30%	5.57%

Muni interest income also doesn't count toward the 3.8% 'net investment income tax' that serves as a drag on income from stocks and other bonds, and it doesn't increase the adjusted gross income on your tax return, which can be used to calculate the Medicare surtax.

What does any of this have to do with investing quirks? Last year, Munis were popular with investors, to the point where they were selling at a yield equivalent to 67% of the yield on Treasury bonds of comparable maturity. The tax-equivalent yield was often less than with comparable corporate bonds.



Today, in stark contrast, thirty-year AAA municipals offer about 106% of the yield of comparable Treasuries. The tax-equivalent yields are the highest since late 2020—and at these fire sale prices, demand, due to the recent price decline, has dried up. At last count, \$1.2 billion worth of Muni bonds stood at auction, with no takers.

Sources:

<https://www.cpapracticeadvisor.com/tax-compliance/news/21263367/tax-pros-and-cons-to-municipal-bonds>

<https://www.advisorperspectives.com/articles/2022/04/07/muni-bonds-close-worst-quarter-since-1980s-down-more-than-6>

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