Municipal Bonds: Opportunities in the Tax-Exempt Market

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David Hagee: Hello, and welcome to Conversations with Commerce Trust, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust.

Today, we're joined by our Director of Fixed Income Portfolio Management and Lead Portfolio Manager for Commerce Tax Exempt Strategies, Brian Musielak. Welcome to the podcast, Brian.

Brian Musielak: Thanks, David. Appreciate you having me.

David: Excited to have you here. I think it's long overdue that we've had this conversation. Certainly, this tends to be one of the more talked-about items.

As we think about munis (municipal bonds) and tax-exempt securities in general, who are your typical investors in these securities?

Brian: So, really, private clients, high-net-worth clients are our typical investor. There are companies out there, insurance companies that do benefit. But of course, the biggest benefit to municipal bonds is the federal tax exemption. So if you find yourself in the highest tax bracket or one of the higher tax brackets, typically, muni bonds make the most sense for you, right?

So they generate income, and unlike a corporate bond or a CD (certificate of deposit) or Treasury (U.S. Treasury securities), individuals will not be taxed, at least at the federal level. And in some cases, like in Missouri, you can also get a state tax benefit as well.

The issuers, in order to get that, the IRS requires issuers, you know, to be a state and local government, a non-for-profit. You have to be eligible in a sense, some taxing districts, special taxing districts, will get access to it. And then also the proceeds, how you spend the money. So if the city of Clayton, (Missouri) is issuing debt, issuing munis to build, you know, roads or bridges, that's public goods. So, then it is exempt from federal taxes.

But the City of Clayton can also issue bonds to benefit a private entity. In those cases, those bonds will be taxable. So there is such an animal out there as a taxable Muni, but our focus here is, of course, on the tax exemption, and that is why our private high-net-worth clients tend to gravitate [to] them because they often find themselves in the highest bracket.

David: So that brings up a couple of questions. You know, as we think about munis, you know, what sort of tax bracket should we be thinking about for your average investor to jump into?

Brian: Yeah, and a lot of that depends on the market, right? So I think there's a misconception that all bonds move the same, right? Interest rates all move the same, bond yields all move the same. And this year is a great example of that not being the case. So I would say typically historically in the mid-20s (percent tax rate), you would have to find yourself is kind of the over/under.

Certainly, once you get up into the 30% or higher (tax rate), then tax-frees (tax-free bonds) almost always make sense. But we've got a unique situation now where the muni market has really underperformed this year, and so yields are quite elevated relative to, say, taxable treasuries or corporate bonds.

And so, we found investors that you know are clients that are even in lower (income tax) brackets, and once you run the math, it actually makes more sense to be in tax-free munis where in some cases that would not be the case.

David: Yeah, so that's a great point. It's really a conversation that you have with people around your unique situation to see whether they make sense or not for you. Certainly, you know their fixed income exposure, as you said, all is not created equal. But it is somewhat of an equation for you to be able to figure out from a yield perspective whether you'd be better off in taxable bonds or tax-exempt bonds.

As you mentioned, you know these are a bit of a unique structure out there. You have, you know, a tax-exempt interest because these are issued by entities that are sort of public entities that could use the lift of having to pay less interest out there. Any other features we should be considering when looking at munis?

Brian: What's unique about the muni market is a couple things. One is it's what we call retail-dominated, meaning that if you break down the holders of municipal bonds, about 45% are classified as "household." Now, that ranges from individuals buying bonds in a brokerage account where they're directing the trades to what's called professional retail, which is hiring someone like us to manage a separate account that you know can manage a portfolio of securities.

And so, what makes that unique is that investment bankers and issuers tend to get away with some things that they wouldn't get away with in the corporate universe when you're dealing with institutional investors. And the biggest is optionality, right? So most of the muni bonds that are issued have some type of call, which means that the issuer has the right to take the bonds away prior to maturity.

Now this is a stated call. It's well known when you're purchasing bonds, but that can be the tricky part about individuals buying bonds. Especially over the course of time, you kind of lose track of those calls, and that's an option that the investor is short, right? Meaning that in most cases, they're only going to call that bond away when interest rates are lower, which then forces investors to reinvest at lower rates.

So that's something that is unique to the muni market that you again you don't see in the Treasury market, you don't see in the corporate bond market for sure, because the institutional investors would really penalize those issuers and really raise borrowing cost.

David: Yeah, so with those two sort of pieces out there, the optionality factor that munis have and the lower relative interest that you receive to taxable bonds, those often lead us to having, you know, pretty robust conversations with people.

As we look into 2025, I've noticed, as you mentioned earlier, it's the municipal market or the tax-exempt market has underperformed the taxable market. Maybe we could talk a little bit about that for a minute.

Brian: Yeah, there's a couple of things going on. The biggest dynamic by far is supply, right? So new issue bond deals, I think most folks have voted on a school district bond issue. So the new issue market right now, you know, last year is about $500 billion. We're running about 23% ahead of that.

Last year was a record issuance, and so I think a lot of it really just gets down to pent-up demand. You know, you had the sticker shock of 2022 with the great reset. Everyone kind of sat on ’23 (2023). You had all this pent-up demand, and now in ‘24 (2024) and ‘25 (2025) we're seeing massive amounts of issuance.

And most of these state and local governments, they kind of look at their debt service like an individual, in some cases, where they just want to stretch it out. They want the lowest payment they can get. And what happens is they start issuing more long-term bonds. And in our market, there's just not a natural institutional buyer for long munis. You have some mutual funds out there that can do that. Again, that's retail, or you have some insurance companies.

But say in the corporate market or even the Treasury market, you've got pension funds, you've got endowments, you've got global investors, all of which can buy long-duration assets. In our market, you're really relying on retail, and most retail investors don't want to buy 30-year bonds.

And so we have a situation, the underperformance has really come all from more intermediate, what we call intermediate maturities to longer term maturities. So those yields have actually gone up about a half [of] a percent this year, whereas you look at the 30-year Treasury, it's about unchanged. So again, that gets into a situation where normally municipal bonds will follow treasuries, but because of the supply impacts, you know, we've seen them really underperform, which presents a nice opportunity.

David: So maybe to quantify that that trading relative to Treasuries, historically muni bonds have traded somewhere around what, 75% to 80% and where are they trading at today in terms of the yield available on Treasury?

Brian: Yeah, so if you look at intermediate, say call 10-year bonds, you know you're trading around that 80% level. You look at 30-year bonds, you're north of 100% and that's for the highest quality bonds. So we, you know, the natural what they call natural AAA rated, we can still find very good high quality bonds, say in the 10-year space at 3.75% and if you go out 15 years, you can get 4.25%. And so, once you run those taxable equivalents, they are very attractive. I mean, you're looking again at 3.75% you're looking at north of, you know, probably right close to 6% for those in the highest tax bracket.

And so, meaning that you'd have to, if you're going to buy a CD or buy a Treasury market, Treasury bond, corporate bond, you'd have to get north of 6% for that to be equivalent. And we would argue outside Treasury bonds, we, you know, munis carries less credit risk, especially relative to corporates (corporate bonds).

David: Yeah, certainly relative to history, I would say those are somewhat outsized yields relative to their Treasury comparisons there. You know, the other thing that munis always seem to be in the news for is that because they have this tax exemption, they're somewhat under a threat.

You know, what have we seen on the legislative front so far in 2025, as we've had a very full legislative slate so far?

Brian: Yeah, that's it's always a drag on our market anytime there's major tax legislation, right? And while it's never been, it was never proposed in terms of eliminating the exemption, that's always kind of thrown out there as a possible threat. It was spared on the Big Beautiful Bill (One Big Beautiful Bill Act). Muni exemption still exists.

We have always felt that's a very low risk probability. The amount of revenue raised is fairly small, and you know you would cut off funding if municipals were unable to access the tax-free market, which again relies on retail investors and banks. And the only reason either one of those two investors buy it is because of the exemption.

If you eliminate that, I mean, you would cut off funding for thousands and thousands of very small and you know, local governments, hospitals, smaller universities. Yeah, the bigger issuers could still survive and issue debt, but the market is so fragmented, and so I think it would just a cost-benefit analysis in our view, it's just not worth it.

David: Right. Though it continues to be an issue in front of us. And yeah, I agree with your point that at the end of the day, you can't starve off these municipalities and these different entities of their funding source. I mean, this is what's building new schools and buying new fire engines. So you need, you need to have some sort of vehicle out there where they can access the capital markets for these larger investments.

Speaking of other aspects of the muni market, what economic factors do you see driving muni returns? And then also relative to Treasuries, how do you see that moving?

Brian: Yeah, well, I mean, no question, the Treasury market's going to drive, right? The Treasury market munis will ultimately follow what Treasuries do. That's going to be more based on the economy, where inflation is. That's a debate for another podcast, right? But relative to Treasuries, we feel like munis will have a better second half of the year.

And there and there are certain spaces that we really like, and it's more, you know, we try to go into areas that, you know, have some manageable problems. You look at healthcare, for example, right? So part of the tax legislation was a cutback in Medicaid. And so, what happens again in the muni market because it's retail-dominated, a lot of broad brushes are painted, meaning that all the hospitals that issued debt kind of get caught up into this concern about Medicaid cuts.

And you know, we look at some of the bigger systems that have very low Medicaid exposure, it could be, you know, less than 10%. But because of the legislation, you get a lot of individuals that say “don't show me any hospital bonds.” And so, we go into areas like that where we can do the credit work, we can find out situations that now we can get more yield because of this, but we don't feel like we're taking on a lot of credit risk.

David: You know, mentioning credit risk, I think, is an important piece here. I've always been struck by while they have the same rating system as taxable bonds, so they would have the same rating scale as, say, a PepsiCo bond. The amount of defaults in munis is dramatically different than what you'd see on the corporate side or on the credit side, as it is known on the taxable end of things. Maybe you could talk a little bit about how resilient municipal bonds have been.

Brian: Yeah, they've been very resilient, and of course, you get the headlines of say a Puerto Rico or the city of Detroit. Those have been well-telegraphed problems for decades-long time periods. But for the most part, you're looking at minuscule default rates on investment-grade rated munis.

To the order of about a third of what, say, corporate bonds will default at. And I think the biggest difference is one, we don't have equity stakeholders, right? I think that's what creates most of the problems in the corporate bond market is you have equity stakeholders that want to put on leverage, they want to goose the stock price, all things that bondholders don't like to hear, right?

We want safe balance sheets, lots of cash, lots of liquidity that doesn't drive stock prices. The other thing is the power to tax, right? It's the power to tax to come in, raise debt service an unlimited amount in order to cover debt service. That is clearly not something that's afforded on the corporate bond side.

David: Yeah, that a great point that, you know, as you look at this especially when you're buying general obligation bonds, they have the power to tax. And then certainly you know in some other revenue type situations, you know, there is a steady stream of income that just prevents them from having the defaults like you would see on the taxable corporate side.

You know, typically inside the taxable bond market, as you mentioned earlier, you basically have a span of zero to 30 years that you have a choice of investing in. Here, it's a little more capped just because retail investors don't have a big appetite for buying 30-year bonds. You know, how do we think about the duration of a portfolio?

Brian: You know, in our process, it's so very customized. And so, our clients, we want to have conversations with them to say here's where the market is, and if you're comfortable buying longer-term bonds, we think it's, I think long-term it's a great opportunity to do that.

David: Right, that as you mentioned earlier, you see a good amount of value in longer-dated muni bonds where you know in some cases, they're equal to the yield that you would receive on a Treasury at this point.

Well, Brian, thanks for the interesting discussion. For more on this topic and others, please visit www.commercetrustcompany.com for our Midyear Outlook as well as additional commentaries. If you’ve enjoyed what you’ve heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from.

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