KARPUS INVESTMENT MANAGEMENT

COMMENTARY

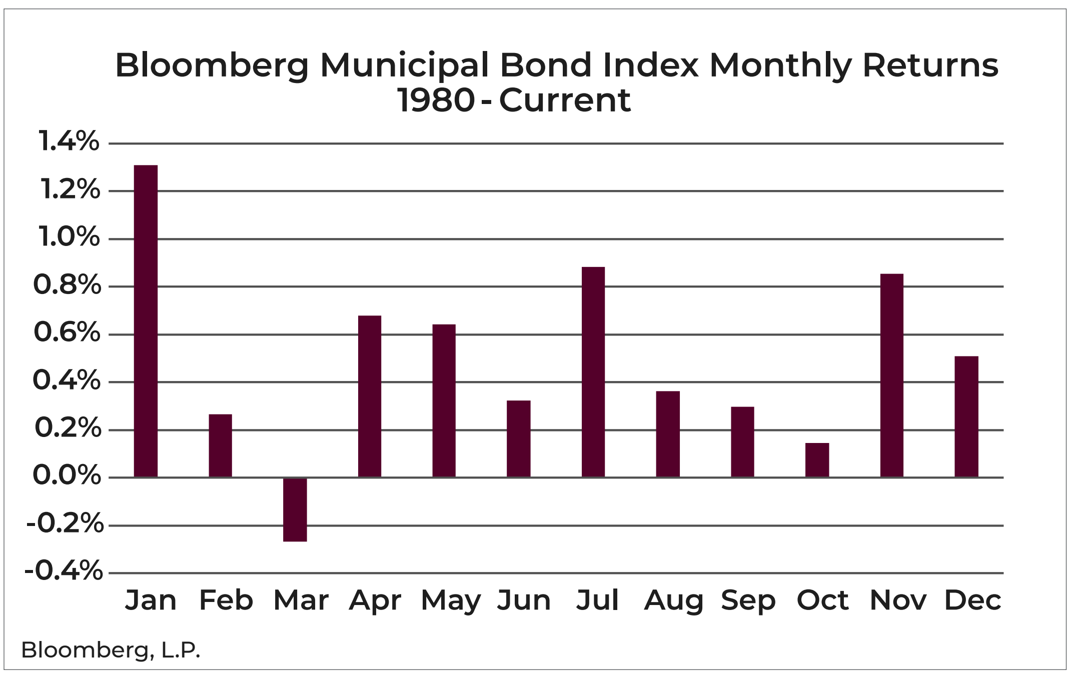
February 2025

Municipal Bonds and the January Effect

Municipal Bond investors care about taxes. Sure, it feels good to support schools, hospitals, and if you're inclined, the construction of the new Buffalo Bills Stadium, but in the end, after-tax income is the goal. This is what makes these bonds so sought after. Ironically, taxes are what make some of these so disposable as well. It turns out income is only part of the story. In the case of bonds funds, when the municipal variety are held by investors at less than they were purchased for, capital gains taxes are brought into the decision process. If an owner can sell one fund at a loss in exchange for a fresh new fund, they often do. While this is logical, it can create excess selling pressure for no other reason. It is true that humans have the capability to think long-term, but often we find ourselves acting at the last minute. And last minute for Uncle Sam is every December.

The double-edged sword of hyperfocus on taxes, both income and capital gain, creates opportunities for those who know the drill. Looking at the Bloomberg Municipal Bond Total Return Index, we see that once the new tax calendar year refreshes, municipal bonds tend to appreciate. Looking back to 1980, January is the best performing month for the index, and by a margin. In fact, this is not due to an outlier or two as January has the second highest percentage of positive monthly returns at 82%, only behind July at 89%. As municipals typically pay interest twice a year, demand for reinvestment after January and July coupon payments plays right into this tendency. When it comes to downside, January's biggest loss puts it near the best as well at -2.7%, only behind February at -2.1%.

The aforementioned analysis pertains to the broad market, but how does this impact the vehicles that invest in these, such as closed-end funds? The First Trust Municipal Closed-End Fund Total Return Index, which goes back to 2006, magnifies the sentiment laid out above. January is the best performing month, this time doubling the next best month at 2.7%. Further, it is by far the most likely to be positive at 84%. As seasoned investors learn, fundamentals matter, but so do technical and historical trends as we can see here.



While January has come and gone, there is still reason to look towards these bonds. Invesco points out that, despite the adage that gridlock is good for financial markets, four of the last five unified governments have benefitted municipals, especially issues lower down the credit ladder. Beyond this, higher absolute yields may help total returns going forward. The BVAL AAA 10-year Municipal Bond yields 3.1% which puts it in the 90th percentile of payout ratio since 2009.

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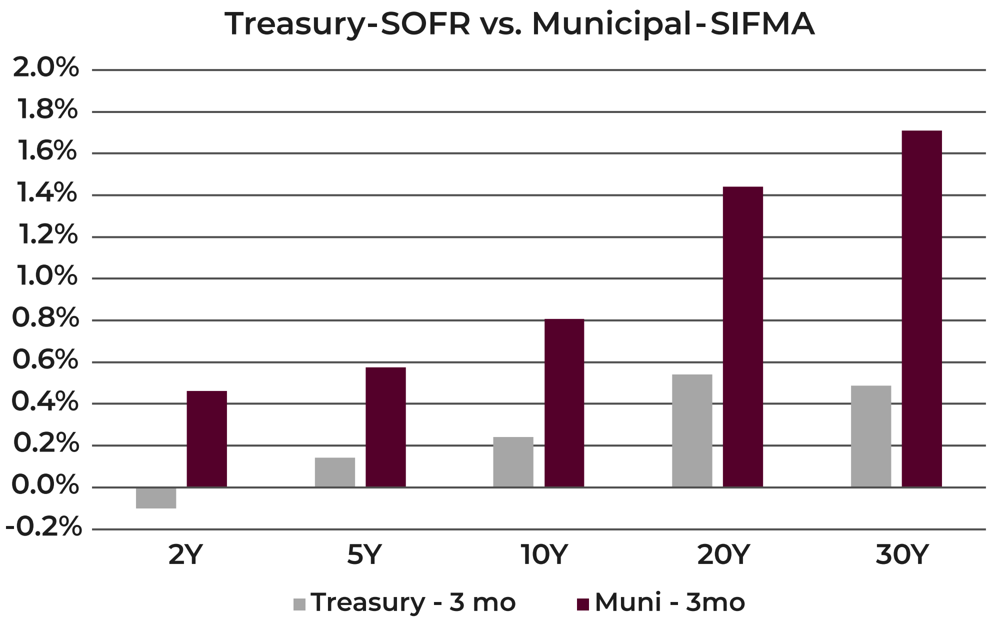
Additionally, many closed-end funds utilize leverage to boost returns by borrowing at short-term rates to achieve higher long-term returns. Without the kinks displayed in the Treasury yield curve, the municipal yield curve appears more normal and more suited to gearing a portfolio for the long-term. This difference in short rates (a proxy for borrowing costs) against long rates (a proxy for reinvestment rates) is shown below.



Bloomberg, L.P.

While positive, this January did not fully live up to the hype. The Index returned 0.5% which is right in line with the average for all months. If we look deeper, there are a few possible reasons for this. First, the California wildfires have worked out to be the costliest natural disaster to date, and municipal bond funds focused on the state lost value in January. As states rely on Federal funding, the shock Federal spending freeze led to local government confusion. We believe it is possible that the new administration's policy headlines are simply bargaining chips to exert targeted pressure. Adding the municipal tax-exempt status to the potential for cuts only increases opportunities for mispricing.

When the dust settles on the direction of policy from Washington, the demand for municipal bonds may come back to life. While risk is ever-present in all investments, after-tax yields and special situations make the municipal space intriguing for those paying attention in 2025.

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