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Another Year of Fear for Municipal Bonds

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Facing down analyst ··Meredith Whitney has paid off for municipal-bond investors—so far. Since her famously pessimistic December 2010 appearance on "60 Minutes," the S&P Municipal Bond index has returned 13.4%, beating Treasurys and high-yield corporate bonds. But while 2012 isn't likely to see the end of the world, muni investors won't find it as easy as last year.

Tight supply of new munis and zero interest rates—forcing investors to search for yield—have pushed money back into muni funds and boosted prices. Yields are now very low. Triple-A-rated bonds maturing in 10 years now yield about 1.8%, according to ··Matt Fabian of Municipal Market Advisors, or about 3% pretax. That is a percentage point above Treasurys. But then muni bonds are less liquid and often offer poor disclosure.

The risk isn't necessarily one of outright default by a municipality. MMA says default rates are highest among issues linked to community-development districts and retirement communities—both exposed to weak real-estate trends.

In contrast, the default rate for tax-backed general-obligation bonds, about 40% of the market, is just 0.01%. **Underlying all this, state tax collections rose for seven consecutive quarters up to September 2011, according to the Nelson A. Rockefeller Institute of Government.**

But the U.S. economic recovery remains sluggish. Until now, rather than bondholders, communities have tended to bear the brunt of strains in local finances, as falling public-sector payrolls demonstrate. There is a political limit to such sacrifices. And while cheap money fuels muni purchases, issues ranging from potential euro-zone fallout to lurking public-sector pension holes will provoke at least the occasional dire headline. And in a fixed-income market with yields this low, and a lot of retail investors, headlines are the last thing you need.