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Advisers: Complex and conflicting issues affecting today's market

Houston-based wealth advisers answer questions about the current market and the advice they are giving clients.

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Q: Municipal bonds were seen as a safe haven in 2008. But today we read about problems in that market as cities and public agencies struggle with debt loads. Is there any hope for muni bonds as a long-term investment?

A: The warnings about municipal bonds revolve around three primary issues: operating budget shortfalls; the amount of municipal debt outstanding; and growing concerns about unfunded pension liabilities. The more we dig into the fiscal problems facing many municipal bond issuers, the more potential pitfalls we see for municipal bond investors. We agree with portfolio managers who trade in this market and predict an increase in default rates and headline risk going forward. That said, we believe our fund portfolio managers possess fundamental tools for navigating these risks: solid credit analysis and experience analyzing the supply and demand dynamics of the municipal market.

We also want to keep the positive considerations in mind. First, many of the municipal bond managers that we research have said there is no shortage of good, solid municipal bond issues still available in the market. Second, municipal bond yields versus comparable maturing Treasury yields are at higher-than-average levels. Third, increasing tax rates should also increase demand for municipal bonds as the extension of the taxable Build American Bonds program has removed supply from the tax-exempt market.

Although it has long been a market with low default rates and seemingly stodgy government issuers, the municipal market has seen more volatility in the last few years than investors ever expected. However, the research we have compiled to date has not caused us to recommend selling municipal bonds.

Q: Describe one sector where you see room for growth this year — one that perhaps you suggest investors explore.

A: Emerging markets. Their macro fundamentals have improved over the past several years. Exports have risen strongly, helping many emerging countries improve their balance sheets. Finally, and more importantly, per-capita incomes have risen impressively over the last several years. This could serve as an important driver of corporate earning over the long run.

There are also financial and economic reforms that are taking place in emerging-market countries. Local debt markets are becoming more developed and lowering their reliance on foreign-currency debt. This will also give local companies easier access to capital, which will stimulate growth in the local economy. Monetary policies are also improving. For example, before the onset of the financial crisis, Brazil allowed its currency to appreciate in order to combat inflation.

Investing in emerging markets does come with significant risks. A key risk is that emerging-market companies' profitability will suffer if the developed world enters another recession or experiences anemic growth. In addition, an increase in risk aversion will negatively impact this asset class as it did in the recent credit crunch. We also believe that as emerging markets and the rest of the world come out of the current slowdown or contraction period, risks of inflation may resurface. Emerging markets experienced a significant rise in inflation this year primarily due to rising food and commodity prices. ■

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