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No Respite in Muni Money Market Rout Seen as Key Rate Surges.

A corner of the municipal-bond market that has quietly enjoyed near-zero borrowing costs for more than six years has seen interest rates spike by nearly 7,000 percent since February as investors flee tax-exempt-money-market funds.

And it may soon get worse with investors starting to price in higher benchmark rates in recent weeks. While the Federal Reserve isn't seen tightening at this week's policy meeting, U.S. central bankers may still boost rates as soon as December, futures contracts indicate.

"If the Fed hikes, you could see higher short-term rates," said Anthony Valeri, fixed income strategist for LPL Financial in San Diego. Investors in munis with yields that reset periodically "will see higher yields," he said.

Since the Fed raised interest rates in December for the first time since 2006, municipal-bond investors have enjoyed strong returns as most state and local governments have seen borrowing costs drop as inflation remained subdued. While another Fed hike could once again benefit the $3.7 trillion municipal-bond market, variable-rate borrowers are being hit with higher yields as investors bail out of municipal-money-market funds in advance of new regulations taking effect Oct. 14.

Since August, 10-year municipal bond rates have risen 13 basis points to 1.56 percent, already the biggest monthly increase since May 2015. The Federal Open Market Committee "appears to be split" on whether to raise rates when it's next meeting winds up Sept. 21, Citigroup Inc. said in a report Sept. 12.

Municipal money-market assets have shrunk $110 billion year-to-date, according to Bank of America Merrill Lynch data. They're now at the lowest since 1999 as investors shifted money into funds that buy only government debt, which are exempt from the new Securities and Exchange Commission rules that require floating net-asset values and impose liquidity fees and redemption suspensions under certain conditions.

Since the first of the year, the yields as measured by the SIFMA Municipal Swap index, a measure of tax-exempt debt with rates that reset every week, have risen to about 0.7 percent from 0.01 percent, the rate at which it had been near for about six years.

"The fact that SIFMA has increased by 70 basis points is pretty incredible," said Matt Posner, principal with Court Street Group LLC in New York. "That's primarily the result the the new regulations."

The spike has made it difficult for issuers of short-term debt with rates that reset "to take advantage of lower rates" in the municipal-bond market, said Rob Novembre, chief executive officer of Clarity BidRate Alternative Trading System, a division of Arbor Research & Trading LLC that is being created to handle remarketing of such debt.

“Issuers of VRDOs are losing their ability to take advantage of low rates because they’re trading at taxable levels,” said Novembre.

Municipal issuers with short-term debt tied to swaps also have seen no benefit in the rise of short-term rates as the drop in long-term borrowing costs has flattened the yield curve, leaving issuers still owing large sums to unwind the hedge agreements many entered a decade or so ago. They “all are so deep underwater it’s horrible,” said Andrew Kalotay, a specialist on debt management and derivatives.

“Long-term rates have come down since the Fed increased rates,” said Bryan Kern, managing member of KPM Financial LLC, a swaps adviser based in Charlotte, North Carolina. “For a lot of folks with swaps on their books the liability has grown.”

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