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What Does a Rate Hike Mean for Muni Bonds?

When the Federal Reserve raises interest rates, it's a signal that economic growth is accelerating and needs less handholding from the nation's central bank. For example in June, the Fed announced it was raising interest rates by one quarter of a percentage point and cited a strengthening labor market and moderately growing economic activity.

But what does that hike, which raised short-term interest rates to a range of 1.00 percent to 1.25 percent, mean for the municipal market?

It can be tempting for investors to think that a rate increase will have a wide-ranging effect, but in reality it usually has a muted impact. Variable-rate debt and other short-term bonds might see a slight uptick in interest rates. Still, rates are near historic lows which means a rate hike shouldn't dampen governments' bond refunding activity.

Meanwhile, rates on long-term debt shouldn't see much of a change. That's because the yield curve eventually flattens — so a slight change in short term rates typically won't dramatically influence longer term rates.

In fact, experience has shown that a hike in short-term rates can actually cause a downward tick in long-term rates. For example, between 2004 and 2006, the Fed raised the short-term rate from 1 percent to 5.25 percent. During that time, the rates on a 10-year Treasury bond only went up a half percentage point. Meanwhile, yields on the 30-year bonds ticked slightly down. Why? Because when short-term interest rates are increased, it actually dampens the impact of inflation, which is what plays the larger role in setting long-term interest rates.

Long-term bonds, however, are vulnerable to other federal policy decisions. For example, in late 2016, long term interest rates saw a temporary uptick as financial markets began to price in some fiscal stimulus from the incoming Trump administration.

Lastly, good old-fashioned supply-and-demand also has a more direct impact on the muni market's long-term rates. Although last year's total issuance – more than $445 billion – was the highest in several years, this year's total is on pace to be below that. As long as demand for munis outweighs supply, interest rates for most quality issuers should remain relatively low.

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