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[Two-Month Muni Rally at Risk After Market Wanted More Dovish Fed.]

- **Municipal bonds are headed for a 0.8 percent return in 2018**
- **Yield on 30-year top-rated munis has fallen since November**

For the $3.8 trillion municipal-bond market, all eyes were on the Federal Reserve to figure out whether better performance is ahead in 2019.

State and local debt was headed for a two-month rally amid expectations that the central bank was closer than previously thought to pausing its cycle of interest rate hikes. At Wednesday's meeting, Fed policy makers raised interest rates for a fourth time this year but pared projections for hikes in 2019 to two rather than three. Firms like BlackRock Inc. said that could bolster municipal-bond returns. Higher interest rates hurt the price of munis.

The benchmark yield on mid- and long-dated muni bonds declined 2 basis points after the Fed's announcement. Shorter-dated securities fell by 1 basis point.

"We think the Fed is getting closer to a pause or maybe even a peak in rates," RJ Gallo, a senior portfolio manager and head of the municipal-bond investment group at Federated Investors, said during a Bloomberg Television interview on Wednesday before the announcement. "If that's the case, that's constructive for high-quality fixed-income — that's munis. Munis can benefit from an end to the upward rate cycle."

Municipal bonds are headed for a 0.8 percent return in 2018, pressured by both rising interest rates and less buying from banks and insurance companies under a lower tax rate. Yields on 30-year top-rated municipal bonds have fallen since the start of November to 3.1 percent, but they're still over 55 basis points higher than where they started 2018.

If policy makers do limit expected rate increases in 2019, "they're admitting that growth expectations have diminished, which would be positive for bonds," said Patrick Tucci, a fixed-income portfolio manager for Foresters Investment Management Company, Inc., which oversees $1.5 billion in municipals.

The firm is overweight the 20-year part of the curve and is considering opportunities to buy 30-year bonds, he said. "From a muni perspective, this is a positive time to be long," he said.

Jason Appleson, a portfolio manager at PT Asset Management LLC, said the municipal market also faces other potential tailwinds at the start of 2019, such as seasonally light supply in January. "If rates come in as expected and we don't see a considerable amount of rate volatility, I absolutely think munis could do well relative to Treasuries," he said.

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