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Municipal Bonds Look Unappealing Despite Recent Demand.

Municipal bond investors don't seem concerned about the threat of inflation or higher rates because they are accepting rock-bottom yields and record-tight yield relationships relative to U.S. Treasuries.

Benchmark 10-year munis with Triple-A ratings traded Wednesday at just 0.68%, or roughly 60% of the 10-year Treasury yield of 1.14%. At the start of the year, the yield relationship stood at 75%. It got as high as 300% during market dislocations last March, when munis yielded much more than Treasuries. That spread has averaged about 80% in recent years.

Top-grade munis offer little or no after-tax yield benefits to investors—even those in higher tax brackets. The top federal income-tax rate is now 37%.

Several factors have driven the strength in munis this year, including record monthly inflows of \$12.5 billion into muni mutual funds during January and a relatively light new issuance.

“New supply underwhelmed lofty expectations in January as issuers took a wait-and-see approach on the new administration,” said a February report by Peter Hayes, head of the municipal bond group at BlackRock, James Schwartz, head of municipal credit research, and Sean Carney, head of municipal strategy. “Taxable issuance remained proportionally elevated at 29% of total supply, depressing traditional tax-exempt issuance. In the tax-exempt market, reinvestment of income from maturities, calls and coupons outstripped issuance by nearly \$16 billion, creating a powerful tailwind. New issues were oversubscribed by 11 times on average.”

The municipal market returned 0.6% in January, besting the Treasury sector. The BlackRock muni pros wrote that the high-yield muni market was a standout in January, gaining about 2%, as investors gravitated toward lofty yields, with tobacco bonds and Puerto Rican debt showing some of the market's largest gains.

The iShares National Muni Bond exchange-traded fund (MUB), one of the larger muni ETFs, is up about 0.7% so far in 2021 and traded Thursday around \$117.80. Reflecting the strength in the high-yield muni market, the Nuveen Municipal Credit Opportunities fund (NMCO), a closed-end fund, has returned 10% this year and trades at \$14.20 a share, a roughly 4% discount to its net asset value.

Barron's viewed munis unfavorably in a year-end outlook for income-producing securities. BlackRock takes a more upbeat view of the sector.

“While rich valuations will cause a drag, we expect strong demand to continue outpacing an elevated but manageable level of issuance. We believe fundamentals will likely benefit from additional fiscal aid, and vaccine distribution should support longer-term revenue normalization. As the new administration lays out its agenda and tax policy comes into focus, we anticipate heightened demand for tax-advantaged assets such as muni bonds,” the BlackRock group wrote.

Barron's

By Andrew Bary

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