Bond Case Briefs

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Morgan Stanley's Outlook for Munis in 2014 isn't Pretty.

In most likely scenario, bonds expected to lose as much as 4.1%

This year has been tough for municipal bonds, and unfortunately for investors, it’s going to get worse before it gets better, according to Morgan Stanley Research.

Morgan Stanley forecasts an 80% chance that municipal bonds will lose money again next year, primarily because of rising interest rates. Year-to-date through Tuesday, the average national intermediate-term bond fund is down 2.16%.

Morgan Stanley’s base-case scenario, detailed in its “Municipal Bond Outlook for 2014” research note, calls for municipal bonds to lose between 1.7% and 4.1% next year as interest rates rise due to a strengthening economy and the beginning of the Federal Reserve’s move to cut back on its asset purchasing program, known as quantitative easing.

The forecasters believe there is a 60% chance that the base case will play out.

Bond prices move in the opposite direction of interest rates, and Morgan Stanley’s base case calls for the yield on the 10-year Treasury to rise to 3.45% next year. It was trading at 2.83% Wednesday following a strong November jobs report from payroll processor ADP Inc.

The U.S. private sector added 215,000 new jobs in November, according to ADP, better than the 173,000 expected by economists.

The worst-case scenario for municipal bonds, which Morgan Stanley says has a 20% probability, would see U.S. economic growth continuing to surprise on the up side and the 10-year Treasury yield topping 4%. In that case, munis could lose between 6.2% and 7.8% next year.

Muni bonds have developed an “outsized vulnerability” to interest rates relative to other fixed-income assets, according to Michael Zezas, a municipal bond strategist at Morgan Stanley.

“In recent years, muni performance hinged on lower rates moves, an improving credit story and investor thirst for yield,” he wrote in the research note. “This resulted in valuations that amplified munis’ vulnerability to higher rates.”

At muni bonds’ current yields, it would only take an interest rate move of 34 to 44 basis points to cause returns to go negative. That’s better than it was at this time in 2012, when muni bonds only had a cushion of about 18 basis points.

The good news is that as rates rise, the cushion will continue to grow and eventually the falling price of municipal bond funds will translate into yields that are enticing enough to even out the reduced interest rate risk, Morgan Stanley predicts.

Enticing yields might be the only thing that can get investors back into muni bonds. Right now, they’re in the midst of their worst selloff ever. November was the ninth straight month in which municipal bond funds suffered net outflows, according to the Investment Company Institute. Over that time, more than $57 billion was pulled out.

There is still a chance municipal bond performance will be good next year, Morgan Stanley said, but it would require the U.S. economy to continue its sluggish growth without any improvement.

By Jason Kephart