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Morgan Stanley to Barclays See Second Yearly Muni Losses.

State and local bonds are set for their first back-to-back annual losses in more than three decades after the $3.7 trillion U.S. municipal market suffered its worst year since 2008.

Muni yields will rise as the Federal Reserve begins curbing its bond buying this month, say Michael Zezas, chief muni strategist at Morgan Stanley and Tom Weyl, director of muni research at Barclays Plc. (BARC) Zezas estimates munis will lose 1.7 percent to 4.1 percent this year, while Weyl predicts the bonds will lose 1.45 percent. The last time munis suffered two straight years of losses was 1980-1981, Barclays data show.

The forecasts contrast with 2011 and 2012, when munis gained 11 percent and 6.8 percent, respectively, according to Barclays data. A record wave of withdrawals from muni mutual funds has shown no signs of letting up, with individuals pulling $6.6 billion over the past four weeks, the most since September.

"If rates rise to the level we expect them to over the next couple of quarters, you're still likely to take on negative returns," said Zezas, who correctly predicted in 2012 that state and local debt would decline last year. "We wouldn't add just yet" to municipal-bond allocations, he said by telephone yesterday.

Detroit Shock

The worst losses in five years for state and local debt in 2013 were fueled in part by a broader fixed-income selloff on bets that interest rates would increase. Munis trailed corporate bonds as Detroit filed the largest municipal bankruptcy and Puerto Rico's credit rating fell to the brink of junk, stoking concerns that the commonwealth won't be able to repay investors.

This year's muni losses can be traced to an accelerating U.S. economy, Zezas said. If the growth of gross domestic product exceeds estimates, which Zezas gives a 20 percent chance of happening, munis could decline 6.2 percent to 7.8 percent as price drops overwhelm interest income.

Municipals gained 11 percent in 2011, the sixth-best return of the past 25 years, Bank of America Merrill Lynch data show. That followed a selloff spurred by banking analyst Meredith Whitney's December 2010 prediction of "hundreds of billions of dollars" of local defaults within 12 months.

Four-Year Low

Widespread municipal failures never materialized, with defaults falling to the lowest since at least 2009 last year. State and local governments have rebounded from the 18-month recession that ended in June 2009, with tax revenue growing for 15 straight quarters through the three months ended June 30, Census Bureau data show.

Bolstered state and city budgets provide a cap on how high muni yields will increase this year, said David Dowden, who helps oversee $7.5 billion of local debt at Princeton, New Jersey-based MacKay Municipal Managers.

Weyl, too, predicts losses, though he expects declines won't be spurred by concerns about creditworthiness.

"We do not foresee any major disruptions in the credit markets," Weyl said in a report. "Credit quality remains high; we forecast another year of low default rates; and the major known sources of potential systemic risk have largely faded."

Enough Interest

Other investors, such as Peter Hayes at BlackRock Inc. (BLK) and Chris Ryon at Thornburg Investment Management, are betting the interest earned on municipal debt will outweigh the bonds' price declines through the year.

In 2013, state and local debt had a negative 7.2 percent price return, though just a 2.9 percent total loss because of interest payments to bondholders, Bank of America data show. Four times in the past decade — 2005, 2006, 2007 and 2010 — munis have declined in value yet posted gains overall for investors.

"You collect the income — price return is going to be plus or minus very little," said Ryon, who helps oversee about $10 billion of munis from Santa Fe, New Mexico. "There's not going to be a lot of capital appreciation or capital loss."

Individuals pulled about $62.7 billion from muni mutual funds in 2013, the most since at least 1992, when Lipper US Fund Flows data begin. The current streak of 32 straight weekly outflows, also a record, began in May and will probably continue through the first quarter, said Dowden and Tom Metzold, co-director of munis at Eaton Vance Management in Boston.

The trend may reverse in April once individuals see the effects of increased federal tax rates for the highest earners, said Metzold, whose company oversees about $28 billion in munis.

'Big Checks'

"No one has felt the pain yet because they haven't done their taxes on the increased tax rate," Metzold said. "People are going to be writing big checks because they weren't invested in munis. That's going to be the catalyst" for the outflows to subside, he said.

Zezas at Morgan Stanley (MS) said he expects the biggest losses to take place in the first quarter, when outflows will be a "key risk" for the market. Interest rates will rise 0.35 percentage point through March 31, and then just 0.4 percentage point for the rest of the year, according to his report.

That means the increase in yield will mostly outweigh the gains from interest payments in the first three months of 2014. After that, "the outlook brightens" as the cushion protects against future rate increases and individuals return to the market, he said.

Neutralizing Risk

"We need to go through a somewhat difficult transition to higher rates from where we are now," Zezas said. "At some point later in the year, we'll be able to focus on the more positive aspects of the market."

Issuers from Washington to New Jersey are offering about $1.8 billion in long-term debt next week, data compiled by Bloomberg show. Few states and cities have sold bonds over the past two weeks because of the Christmas and New Year’s holidays.

The interest rate on AAA 10-year munis is 3 percent, Bloomberg data show. That compares with a 2.99 percent yield on similar-maturity U.S. Treasuries.

The ratio of the yields, a gauge of relative value, is about 100 percent, in line with its five-year average. The smaller the number, the more expensive munis are compared with federal securities.

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