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[Tax-Free Bonds Go First-to-Worst on Risk Adjustment: Bloomberg Muni Credit.]

Bets that interest rates would climb, coupled with Detroit's record bankruptcy and concern that Puerto Rico's shrinking economy would make it hard for the commonwealth to repay its debt, undermined the $3.7 trillion local-bond market. Photographer: Jeff Kowalsky/Bloomberg

U.S. municipal debt is set to trail stocks, commodities, Treasuries and corporate bonds in 2013 when adjusted for volatility, halting a two-year streak of outperforming those assets.

Bets that interest rates would climb, coupled with Detroit's record bankruptcy and concern that Puerto Rico's shrinking economy would make it hard for the commonwealth to repay its debt, undermined the $3.7 trillion local-bond market. Investors have pulled money from muni mutual funds since May, an unprecedented streak, Lipper US Fund Flows data show.

Though city and state debt joined a broader fixed-income selloff, the record outflows made munis more of a one-way bet. Benchmark yields have risen in nine of 12 months since setting generational lows in December 2012, data compiled by Bloomberg show. By comparison, Treasury interest rates have climbed in seven months this year.

"Yields pretty much went up most of the year," said Chris Ryon, who helps oversee $10 billion of munis at Thornburg Investment Management in Santa Fe, New Mexico. After a September rally, "you just started moving up higher again."

Munis have declined 0.9 percent this year through Dec. 26 after factoring in trading swings, according to data compiled by Bloomberg and Bank of America Merrill Lynch. Treasuries have lost the second-most, at 0.8 percent, followed by company bonds at 0.3 percent and commodities at 0.1 percent. The Standard & Poor's 500 (SPX) index of stocks, which has surged almost 30 percent in 2013, has gained 2.9 percent on a risk-adjusted basis.

Swing Band

Last year, local debt earned 3.8 percent when adjusted for volatility, and 4.4 percent in 2011, the highest among the assets for both periods. In 2010, munis trailed all areas.

Price swings on local-government obligations are smaller than on other assets in part because the securities don't trade as often. Individuals own about 70 percent of municipal bonds either directly or through mutual funds, Federal Reserve data show. Those buyers typically hold to maturity. About a third of muni trades occur within a month of issuance, according to the Municipal Securities Rulemaking Board.

The relative stability penalizes munis' risk-adjusted returns during years of decline because investors have fewer opportunities to capitalize on price fluctuations. Only in April, September and October did benchmark 10-year muni yields post monthly declines, Bloomberg data show.

Selling Squeeze

An exodus from the municipal market helped trigger the yield increase. Individuals have pulled $60.7 billion from muni mutual funds this year, the most since at least 1992, when Lipper US Fund Flows data begin.

The current streak of 31 straight weekly outflows began in May as investors speculated that a stronger economy would lead the Fed to curb its bond buying, a decision it announced last week.

“For the first five months, the municipal market was operating by the playbook for an environment where rates were sideways,” said David Dowden, who helps oversee $7.5 billion of local debt at MacKay Municipal Managers from Princeton, New Jersey. “In June that all changed, and what we saw was a liquidity squeeze that was specific to the muni market and led to its underperformance.”

Yield Surge

The Fed bond buying helped push yields on 20-year general-obligation bonds to 3.27 percent a year ago, the lowest since the 1960s, according to a Bond Buyer index.

The interest rate has increased to 4.73 percent, eclipsing the 10-year average of 4.41 percent.

“I’m not saying we’re cheap, but last year we were so overvalued that we saw the selloff this year,” Ryon said. “Now we’re more fairly valued.”

Tom Weyl, director of muni research at Barclays Plc, and Michael Zezas, chief muni strategist at Morgan Stanley, predict another year of negative returns in 2014. The securities have dropped 2.9 percent this year without factoring in volatility, Bank of America data show.

Local-government debt hasn’t declined in back-to-back years since the 1980s, according to Barclays data.

The risk-adjusted return is calculated by dividing total return by volatility, or the degree of daily price-swing variation, giving a measure of income per unit of risk. The returns aren’t annualized. Higher volatility means an asset’s price can fluctuate more in a short period, increasing the prospect for unexpected losses.

Supply Slowdown

Issuers from New York to Arizona are offering about $172 million in long-term debt this week, when the market shuts Jan. 1 for New Year’s Day.

The interest rate on AAA 10-year munis is 2.93 percent, compared with 3 percent on similar-maturity Treasuries.

The ratio of the yields, a measure of relative value, is about 98 percent, the lowest since June. It compares with a five-year average of 102 percent. The smaller the number, the more expensive munis are compared with federal securities.

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