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Munis Gain In September Amid Wider Bond Fund Selloff.

Investors across the bond spectrum counted their losses in September.

General taxable domestic bond funds lost 1.60%, according to preliminary data from Lipper Inc.

Prices tumbled across the board, with declines in bond funds sensitive to interest rate news and fluctuations in yield spreads against Treasuries and well as foreign bonds. They were hurt by higher Treasury yields, wider spreads and a strong dollar, BlackRock officials said.

“There’s an expectation of Fed policy normalization,” said Jeffrey Rosenberg, chief investment strategist for BlackRock, which manages more than $1.3 trillion in fixed-income assets. A rise in interest rates by sometime in 2015 was signaled in Fed Chair Janet Yellen’s comments at the Jackson Hole summit in August and backed up by the Federal Reserve Statement of Economic Projections in September, he added.

As a result, investors edged out of rate-sensitive fixed income. Short- and intermediate-term debt funds backtracked 0.53% in September and 0.13% in Q3.

Concerns over falling inflation also negatively affected the performance of inflation-protected funds. They fell 2.35% and 2.15% in the same periods.

But among taxables, bond mutual funds offering foreign exposure were hardest hit.

The U.S. dollar rose about 3.8% against a basket of foreign currencies in September. The strengthening greenback hurt international fixed income, which is mostly denominated in foreign currency, Rosenberg said. Returns suffer as results from foreign currencies are translated into the more expensive greenback.

The euro and yen slid further as economic growth faltered in Europe and Japan, while surging in the U.S.

Emerging Markets

Emerging markets bond funds denominated in local currency slid most sharply: 4.6% for the month and 5% in Q3. International income funds lost 2.66% and 2.60% in the same periods. Hard-currency emerging markets funds — holding debt denominated in U.S. dollars or other major currencies — gave up 2.34% and 2.02%.

Investors lost appetite for risk in September. Longer-term Treasury funds fell 1.17%; corporate single-A rated funds fell 1.09%; and corporate triple-B rated funds lost 1.44%.

The retreat sharpened with lower credit-quality bonds.

High yield spreads — the difference in yield between high-yield bonds and a comparable Treasury — increased by 62 basis points to 425. With rate hikes likely, these riskier investments began to look even less relatively attractive than their risk-free counterparts, Rosenberg said.

High-yield funds lost 2.05% and 2.06% in September and Q3.

Relatively risky flexible income funds dipped 1.31% and 0.71%.

The yield curve steepened slightly in the quarter as the yield on two-year notes rose 10 basis points to 0.58%, while the yield on 10-year notes rose 17 basis points to 2.52%.

Looking forward, Rosenberg expects modest increases in rates over the next three to four months.

“There’s a potential for bigger increases in shorter maturity instruments,” he added.

Muni Moves

Tax-exempts fared relatively better, managing an overall average gain of 0.17% in September and 1.52% in Q3.

Short and intermediate municipal debt funds fared the worst. One big reason: the steepening of the municipal yield curve between one and 10 years.

“The 10-year part of the yield curve in munis underperformed significantly,” said Christopher Alwine, head of the municipal bond group at Vanguard, which manages $750 billion in fixed-income assets.

That part of the yield curve tends to be most sensitive to changing market conditions, and its movement reflected anxiety about rising rates, he added.

Riskier municipal bonds outperformed in September. High-yield debt funds posted 0.58% and 2.40% gains for the month and quarter.

They were helped by the improved fiscal health and creditworthiness of the issuers, as well as the search for yield under current low rates. “Investors have bid up the price of lower-rated bonds,” Alwine said.

Alwine owned a Metropolitan Washington Airports Authority revenue bond issued to finance a light rail project. The bond, with a 5% coupon, matures Oct. 1, 2053, and is rated BBB+ by S&P. Its total return in September was 0.5%.

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