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Pimco Sees Returns Ebbing After Best Gain Since '11: Muni Credit.

With the $3.7 trillion municipal market poised for its biggest annual gain since 2011, this year is going to be a tough act to beat, say Pacific Investment Management Co. and Morgan Stanley.

Returns in 2015 may be less than half of the 8.7 percent logged in 2014 as interest rates have probably bottomed out close to generational lows, according to Pimco, the $2 trillion fixed-income manager, and Morgan Stanley, owner of the world's largest brokerage.

Gains are probably set to diminish as the Federal Reserve wraps up its bond-buying program and prepares to raise interest rates, said Michael Zezas, chief municipal strategist at Morgan Stanley in New York. The prospect of skimpier earnings for investors has significance for municipalities as well: Demand from buyers chasing this year's rally has helped push borrowing costs toward generational lows for officials financing schools, roads and water systems.

"You've already run it fairly far," said Joe Deane, New York-based head of munis for Pimco, whose co-founder Bill Gross departed on Sept. 26. "From these levels, to have this kind of a return, you would have to take interest rates down to some dramatic levels. I don't see that being in the cards."

2015 Call

State and local debt will earn about 3 percent in 2015, said Deane, whose company manages $50 billion of munis.

While that would still mark a second straight year of gains, it may temper the appetite of individual investors, who have poured cash into U.S. muni mutual funds for 13 straight weeks. That's the longest stretch since 2012, according to Lipper US Fund Flows data.

The demand pushed yields on benchmark 10-year munis to 2.05 percent, the lowest since May 2013, after the interest rate fell for three straight quarters. Yields may reverse course in 2015 if investors pull back from local obligations in anticipation that the Fed will raise its benchmark lending rate, Zezas said.

The central bank will lift its target, which has been near zero since 2008, starting in the third quarter of 2015, according to the median forecast of 82 analysts surveyed by Bloomberg. Morgan Stanley expects the Fed boosts to start in the first quarter of 2016.

Base Case

"We expect rates to gradually move higher and volatility to pick up as we get closer to a Fed exit," Zezas said. "Those are things that are a risk in muni performance."

Morgan Stanley's main scenario is for munis to lose 0.88 percent in the next 12 months, Zezas wrote in an Oct. 6 report.

“We more or less expect flat returns as a base case,” Zezas said by phone. “But the skew of potential return outcomes is certainly meaningfully lower than what we’ve experienced over the last 12 months.”

Yields on 10-year Treasuries will reach 3.25 percent in the third quarter of 2015, about a percentage point above current levels, according to the median forecast of 75 analysts in a Bloomberg survey.

State and city debt has defied Zezas’s year-end 2013 forecast. At the time, he laid out a base-case scenario for this year in which munis would lose at least 1.7 percent.

Rebound Year

The return this year follows a loss of 2.6 percent in 2013, S&P Dow Jones Indices show. The assets are on track for their best performance since 2011, when they gained 10.6 percent.

Daniel Ivascyn succeeded Gross as Pimco’s chief investment officer. Gross helped its Total Return Fund (PTTRX) become the world’s biggest bond mutual fund, with about $202 billion of assets, of which 4.2 percent was in munis as of June 30.

After the shakeup, shifts in muni allocations will come from market developments and not Gross’s departure, Deane said.

“They look to all of these specialist desks — do you like your market, do you not like your market? What’s valuable and what’s really rich?,” Deane said. “I don’t think that is going to change.”

Deane and Zezas also have a similar view on where investors should look in terms of credit quality, focusing on higher-rated assets instead of the riskier obligations that have outperformed this year as benchmark yields dove.

Munis in the bottom three levels of investment grade have earned 12.9 percent this year, compared with 6.1 percent for top-rated debt, Barclays Plc data show.

Investors should take the opportunity now to trade out of munis rated one to four steps above junk and purchase higher-grade debt, Zezas said.

Pimco focuses on munis in the single-A range, or four to six steps below top-rated securities, and bonds maturing in seven to 20 years, Deane said.

“With the rally that we’ve had, it just makes us a little more conservative,” Deane said. “If we’re going to put money to work, it’s going to be higher-grade stuff and it’s going to be shorter.”

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