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Record Rally Reaches 10th Month as Volatility Rises: Muni Credit.

The $3.7 trillion municipal market is set to gain in October, weathering the highest volatility since January to extend a record rally.

State and local debt has earned 0.7 percent through Oct. 30, according to Bank of America Merrill Lynch data. The 10th straight month of gains in 2014 marks an unprecedented stretch to start a year since the data begin in 1989. The highest top tax bracket since 2000 is helping fuel demand. Yields on benchmark 10-year munis have dropped 0.1 percentage point this month to 2.12 percent, data compiled by Bloomberg show.

Global financial markets gyrated in October as investors fretted that global growth was slowing. For munis, the 30-day volatility on benchmark 10-year yields reached the steepest since Jan. 14. During a 30-day rollercoaster, interest rates plunged along with Treasuries and then climbed by the most in 16 months as investor demand waned.

“When you look at year-to-date total returns, it’s been pretty impressive,” said John Flahive, Boston-based director of fixed income at BNY Mellon Wealth Management, which oversees about $20 billion in munis. “It just seems we have much more sensitivity, given how low in rates we are, to following the volatility of the Treasury marketplace.”

Until the current rally, the longest win streak to start a year was five months in 1991, Bank of America data show. The 9 percent return for munis in 2014 has defied forecasts of analysts and investors, who predicted a second year of losses after a selloff in 2013.

Instead of rising, yields have dropped, luring states and cities to borrow. Municipalities are on pace to issue $36 billion of long-term, fixed-rate bonds in October, the highest monthly total since March 2013.

Investor appetite weakened after benchmark 10-year yields touched 1.94 percent Oct. 16, the lowest since May 2013. Individuals added $37 million to muni mutual funds this week, down from $444 million two weeks ago and the lowest since August, Lipper US Fund Flows data show.

BlackRock Inc. (BLK), the world’s largest money manager, sold some local debt as yields declined, according to Peter Hayes, who oversees $122 billion as head of munis at the New York-based company.

Ten-year yields then surged 0.16 percentage point to 2.14 percent in the week through Oct. 24, the biggest jump since July 2013, as buyers balked at the lower rates.

Ride’s End

“The mid-month volatility for munis was extraordinary,” said James Dearborn, head of munis in Boston at Columbia Management Investment Advisers, which oversees about $30 billion in local debt. “At the end of the ride, which to some people probably felt unpleasant, we’re at a better, more justifiable level than where we started.”

Muni volatility also rose relative to that on Treasuries. Because individuals own about 60 percent of the municipal market and most debt doesn’t trade on a daily basis, state and local bonds have historically been less volatile than their federal counterparts. Yet on Oct. 27, the 30-day muni yield volatility reached the closest to the measure for Treasuries in three months.

‘Better Place’

As munis swung in value, the market cheapened compared with federal obligations. The ratio of yields on 10-year munis to those on similar-maturity Treasuries rose to 94 percent on Oct. 24, the highest since July. A rising figure signals that state and local debt is increasingly cheap. The measure is still below the five-year average of 98 percent.

“Volatility never feels good, but if we cheapened a little bit to Treasuries, that puts us in a better place going forward,” Dearborn said.

October’s issuance glut may not carry over into the next two months, re-establishing the 2014 trend of slowing supply. States and cities have scheduled $8.3 billion of bond sales in the next 30 days, down from $13.7 billion on Oct. 15, Bloomberg data show. Issuance in 2014 is about 6 percent below the 2013 pace.

The gains in the face of higher volatility may give investors confidence that state and local debt will retain value even if interest rates rise next year, as projected in a Bloomberg survey of more than 70 analysts.

“It all happened so fast,” said Blake Miller, who helps oversee $10 billion of munis at Neuberger Berman Group LLC in New York. “But after going over that speed bump, we ended the month in pretty good fashion, with yields down across the board.”

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