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U.S. Stellar Municipal Bond Returns Set to Dim in 2015.

(Reuters) – U.S. municipal bonds' stellar 9 percent performance so far this year may not continue in 2015 as interest rates are set to rise and dampen returns, analysts and fund managers said.

Munis bounced back from a negative return in 2013, when investors fled the asset class partly on concerns about high-risk situations in Detroit and Puerto Rico. This year, high-yield funds and long-duration munis clocked among the highest returns.

For 2015, investors are anticipating higher interest rates, which could bring the rally to a halt. Bond prices typically move inversely to interest rates, and the U.S. Federal Reserve has signaled it will raise rates in 2015.

"An unanticipated jump in interest rates has the potential to reintroduce households, who are the biggest holders of municipals, to interest-rate risk," said Chris Mauro, head of U.S. municipals strategy at RBC Capital Markets. "This could cause a negative, herd response on the part of these investors, temporarily dislocating the municipal market."

The S&P Municipal Bond Index returned 9.25 percent as of Dec. 17. That beat both its Treasury Bond Index, which has returns of 3.83 percent, and its investment-grade corporate bond index, with returns of 7.28 percent. This year's returns for the S&P Muni index are on track to be the highest since 2011.

"We've had a very good year in the muni market," said Jeffrey Lipton, Managing Director, Municipal Research, at Oppenheimer & Co, pointing to positive flows into intermediate, long-term and high yield funds.

Interest rates on long-term bonds this year have taken the biggest plunge in a decade. According to Municipal Market Data, a unit of Thomson Reuters, the yield on top-rated debt maturing in 20 years and beyond has fallen the most since 2004 on its benchmark scale, meaning the prices spiked during that time.

That's unlikely to be repeated in 2015.

"We're expecting the on-paper returns will end the year (2015) looking somewhat boring but the path to get there will be anything but boring," said Morgan Stanley analyst Michael Zezas. "There is plenty of risk in the market that has the potential to create a fair amount of volatility along the way."

Municipal bond performance could remain positive at the beginning of the year, but overall in 2015 the range could be somewhere between a negative return of 2 percent to a positive return of 5 percent for 2015, said Richard Ciccarone, head of Iowa-based Merritt Research Services.

Constricting supply pushed up returns this year. The amount of outstanding debt, $3.63 trillion, is the smallest in five years.

Issuance so far this year through Wednesday is $312 billion, according to Thomson Reuters data, level with 2013's figure for the year as a whole. Many expect next year's supply to be higher, boosted by bond ballot measures in November's elections and continued demand to improve creaking infrastructure.

"We've gone through a period of time when America has been holding back," said Ciccarone. "Physical structures can only take that for so long."

According to a survey of banks released earlier this month by the Securities Industry and Financial Markets Association, sales of all municipal bonds will likely rise to $357.5 billion in 2015 from $348.1 billion estimated this year.

Inflows into bond funds are also expected to continue. With two weeks remaining in the year, municipal bond funds have received total net inflows of $23.3 billion, compared to record net outflows of $64.2 billion in 2013, according to Lipper.

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(Reporting by Megan Davies, Lisa Lambert, Hilary Russ, Robin Respaut, Karen Pierog, Ed Krudy; writing by Lisa Lambert and Megan Davies; Editing by Cynthia Osterman)