Best Bonds Seen Due Beyond 22 Years as U.S. Expands: Muni Credit.

(Bloomberg) — State and local bonds with the longest maturities are delivering the best returns in the $3.6 trillion municipal market even as investors brace for higher interest rates as the U.S. economy grows.

Munis due in 22 or more years have earned about 1.9 percent in 2015, outpacing shorter-dated bonds and beating the 1.4 percent advance for the entire market, Bank of America Merrill Lynch data show. They're extending a rally after earning 15.5 percent last year, the most since 2009.

Longer maturities are gaining even as the Federal Reserve is projected to raise its benchmark interest rate this year from near zero, where it's been since 2008. That move wouldn't reverse momentum for munis due in decades because interest rates will rise more dramatically for debt maturing in one to three years, said Chris Alwine at Vanguard Group Inc. in Valley Forge, Pennsylvania.

"If the Fed begins to tighten, those increases will hit the front end of the curve more," said Alwine, who oversees $145 billion as head of munis. "And in a world without high inflation, the long end of the curve won't be hit that badly."

Bank's Patience

The Fed last week boosted its assessment of the economy and repeated a pledge to stay "patient" on raising interest rates. It said inflation "is anticipated to decline further in the near term." The bank will boost its target as soon as next quarter, according to the median forecast of 41 analysts surveyed by Bloomberg.

While Fed increases might push up yields on longer-term securities, this year, subdued inflation will keep rates on longer munis from spiking, said Peter Hayes, who manages $114 billion as head of munis at New York-based BlackRock Inc.

"This time, we would argue that the growth is non-inflationary so we won't see that steepening," Hayes said.
The economy will expand 3.2 percent in 2015, according to the median forecast of 84 analysts surveyed by Bloomberg. It would be the fastest growth since 2005.

The Fed's preferred inflation gauge, personal consumption expenditures, rose 0.7 percent in December and has been below the bank's 2 percent target since May 2012. The 54 percent drop in oil since June, to about $49 a barrel, has tamped down inflation. Slower inflation preserves the value of bonds' fixed payments.

Relative Value

Longer munis' relative value against federal debt will also support the securities, said Clark Wagner, director of fixed income at First Investors Management Co. in New York, which oversees $1.5 billion of munis.

Yields on benchmark 30-year munis reached as high as 118 percent of those on Treasuries on Jan. 29, the most since October 2013, data compiled by Bloomberg show.

"That gives it a little cushion if rates rise," Wagner said.

With benchmark yields close to five-decade lows, investors in January poured about $2.5 billion into U.S. muni mutual funds with an average maturity of greater than 10 years, Lipper US Fund Flows data show. It was the biggest inflow in two years.

"They are extending out," BlackRock's Hayes said. "When rates get very low like they are now, investors tend to extend either their duration or they take more credit risk."

Borrower Boon

Declining yields on obligations due in decades have been a boon for issuers borrowing for construction and maintenance of schools, roads and bridges.

Last month, Washington's King County sold bonds backed by sewer revenue to refinance higher-cost debt. The new securities have maturities as late as 2047. The sewer system, the largest in the U.S. Northwest, will save $160 million because of the lower yields, Ken Guy, the county finance director, said in an interview.
"It will save money for our rate payers," Guy said.

The appetite for longer maturities led the county to increase the deal by about $300 million, and then lower yields by as much as 0.05 percentage point across maturities the day of the sale, said Robert Shelley, a financial adviser at Piper Jaffray & Co. in Seattle.

"There's still some investors out there that have cash that they need to put to work," Shelley said. "And debt of municipalities represents good value compared to some of those other options out there."

Supply Equation

The sale was an advance refunding, where proceeds sit in escrow until the original bonds are repaid. With interest rates this low, more localities may opt for such refinancings, said Tim McGregor, head of munis in Chicago at Northern Trust, which manages $30 billion of state and local debt.

"There could be a lot of longer bonds advance-refunded" with shorter maturities, McGregor said. "And that reduces the supply out long."

States and municipalities may sell $335 billion of debt in 2015, Chris Mauro, chief muni strategist in New York at RBC Capital Markets, estimated in December. That includes $55 billion of advance refunding.

"The $55 billion estimate looks low at the moment," Mauro said in an e-mail. "It looks like advance refundings are running well ahead of last year in the first few weeks of the year."

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