Perfection Doesn't Last: Muni Bond Returns to Be More Muted.

NEW YORK — Conditions were nearly perfect for municipal bonds last year, leading to sizable returns. Perfection never lasts, though, and managers of municipal-bond funds are forecasting more modest returns in upcoming years.

The backdrop for municipal bonds last year was as pleasant as the first warm, spring breeze: Interest rates were falling, the economy was strengthening, demand was high for bonds that pay tax-free income and supply was relatively low. Add it up, and the Barclays Municipal Bond index returned 9.1 percent in 2014. Just don't expect a repeat.

"Definitely manage those expectations," says Diederik Olijslager, who co-manages the $3.9 billion USAA Tax Exempt Intermediate-Term fund, among other municipal-bond offerings. "It's fixed-income investing, it shouldn't be 10 percent returns a year."

Gains are still likely in coming years, but managers say they're likely to be closer to 2 percent or 3 percent, depending on the type of bond. Another cloud in the forecast: Managers also expect volatility to pick up following a very calm 2014.

Investors have already had a sneak peek: The Barclays Municipal Bond index fell in February, its first monthly loss since 2013, snapping what had been its longest winning streak in more than two decades. Among the factors affecting the municipal-bond market:

— YIELDS ARE LOW.

Municipal bonds are producing less income than a year ago because their yields key off Treasury rates, and the yield on the 10-year Treasury note is below 2 percent. It was around 2.70 percent a year ago and close to 4 percent five years ago.

Rates are so low, the worry is that they will rise and knock down the price of existing bonds. And the improved job market means most economists expect the Federal Reserve to raise short-term rates later this year.

Conventional wisdom says that investors worried about rising rates should focus on short-term bonds. That's because long-term bonds lock in yields for longer periods of time, which makes their prices more sensitive to rate changes.

But even after the Fed hikes rates, long-term rates could continue to stay low given how weak inflation is. That's one reason Josh Gonze, a portfolio manager at Thornburg Investment Management, is staying neutral on interest rates and refraining from leaning on just short-term bonds. Thornburg manages $10 billion in municipal bonds.

Gonze says he's not willing to bet on where long-term rates will go relative to short-term rates: "I know that I don't know, and I know that no one else knows either."

— SUPPLY IS RISING.

States, cities and other local governments are issuing bonds at a faster pace this year, and when the supply of anything increases, that can push prices lower. Just look at what's happening to oil, where a buildup in supplies has caused its price to more than halve since last summer.

Local governments issued $62.2 billion in bonds through the end of February, a big jump from the $36 billion they issued at the same point last year. Governments are taking advantage of cheap borrowing costs to replace higher-cost debt and pay for new projects.

"They're borrowing money at basically nothing," says Gonze. "If I were a city, county or state, I would go ahead and borrow as much as I could."

— DEMAND REMAINS STRONG.

Supplies are rising, but so is demand, which means buyers are snapping up all those additional municipal bonds.

Individual investors make up the bulk of the market for municipal bonds and they're pouring in billions of dollars each month. They're attracted to the prospect of tax-free income, particularly given higher federal income-tax rates. Income from muni bonds is free from federal taxes and can also be exempt from state and local taxes in some cases.

Municipal-bond mutual funds and exchange-traded funds drew a net $32 billion in investment in 2014. In the first two months of 2015 alone, they've attracted another $8.6 billion. That demand is helping to offset the impact of higher supplies.

— THE ECONOMY IS IMPROVING.

The strengthening job market is helping the finances of state and local governments. A larger workforce means higher collections of income taxes, sales taxes and other revenue. That raises confidence in municipalities' ability to repay their debts.

Managers have concerns about finances in some high-profile areas of the market, including Illinois and Puerto Rico, as well as bonds from government that are reliant on oil-related revenue. But managers say financial strength is generally improving across the country.

— WORRIES ARE RISING ABOUT EASE OF TRADING.

When times are good, it's easy for fund managers to find buyers for their municipal bonds. The concern is what will happen when times are tough.

Historically, Wall Street banks and other broker-dealers have stepped in to buy bonds during stressed markets. In financial-ese, the banks provided liquidity, helping the market to remain free-flowing. But new regulations mean banks are less willing to hold bonds on their balance sheets.

That has several fund managers bulking up their holdings of cash and the highest-quality municipal bonds to help protect them in case liquidity dries up during a sell-off.

By THE ASSOCIATED PRESS

MARCH 26, 2015, 3:06 P.M. E.D.T.