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[Muni Buyers Plow Into Long Bonds to Win Once Fed Increases Rates.]

Municipal-bond investors are snapping up the longest-maturing tax-exempt debt as the Federal Reserve prepares to raise interest rates, even though yields signal it's the worst time to do so in almost three years.

That's because if history is any guide, the securities will be the best performers in the $3.7 trillion market when the Fed tightens monetary policy, a move it may take next week after seven years of holding borrowing costs near zero.

The buying spree pushed the extra yield buyers pick up for holding 10-year debt instead of two-year securities to as little as 1.34 percentage points on Monday, near the lowest since January 2013, according to data compiled by Bloomberg. The shift shows how investors are positioning to gain from higher interest rates, which are typically a drag on returns in the fixed-income market.

The suppressed interest rates on the longest-maturing bonds are also a boon to states and cities because they usually finance infrastructure projects with debt that doesn't come due for decades. They sell short-term securities mostly for cash-flow needs, which have declined as their finances recovered from the recession.

When the Fed last boosted interest rates from 2004 through 2006, munis maturing in 22 years or more delivered annual returns of 6.5 percent, more than triple the gains on securities due in 3 years or less, according to Bank of America Merrill Lynch indexes.

The market is primed for a repeat, according to John Dillon, managing director at Morgan Stanley Wealth Management in Purchase, New York. Analysts at Janney Montgomery Scott and RBC Capital Markets are predicting the same.

“My expectation is that you do see out-performance on the mid-part of the curve to the back-end of the curve,” Dillon said in a telephone interview. “You could get a lot more flattening of the muni curve as we go forward.”

Investors agree. They’ve poured $3.1 billion into long-term muni mutual funds over the course of nine weeks, the longest stretch of inflows in at least a year, Lipper US Fund Flows data show.

Muni buyers have been projecting that longer-dated bonds would fare well once the Fed starts raising short-term rates, with the securities seen as the best positioned to remain stable or gain because of subdued inflation expectations over the next year. There’s a 78 percent chance the Fed will raise its benchmark at its Dec. 15-16 meeting, according to futures data compiled by Bloomberg.

Risk and Reward

Investors usually demand greater yields to own bonds that mature far in the future because of the risk that inflation will erode the value of fixed interest payments. When buyers are confident that inflation won’t pick up, they can capture more yield by extending the maturity of their holdings.

Prices are expected to hold relatively stable: the Fed expects inflation of 1.7 percent next year, according forecasts released in September, less than the 2 percent rate that it targets.

“The risk-reward calculation when you extend duration at this point indicates that people are getting paid for moving out on the curve,” said Chris Mauro, head of muni strategy at RBC in New York. “There doesn’t seem to be a lot of pressure on the longer end of the curve right now given the economic backdrop.”

Benchmark 30-year muni yields touched 3.02 percent last week, the lowest since April and down 0.23 percentage points over a two-week span, Bloomberg data show. By contrast, two-year yields have jumped to the highest since June 2013. That has narrowed the difference between the two to 2.3 percentage points, a 10-month low.

Over the past four weeks, investors have added $1.8 billion to muni mutual funds as the central bank assures markets that the pace of increases will be gradual, the Lipper data show. That suggests investors are less concerned about the impact of a rate increase then they were in September, when they yanked $1.4 billion from the funds in the four weeks leading up to the Fed’s decision.

“Investors should feel comfortable moving out on the yield curve: Long-term rates aren’t going to go shooting up just because the Fed is hiking short-term rates,” said Alan Schankel, a managing director at Janney Montgomery Scott in Philadelphia. “That’s based on a lethargic economic growth scenario and a lack of inflationary concerns.”

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