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U.S. Municipal Bonds on Solid Footing Heading Into 2016.

CHICAGO/NEW YORK Dec 23 – Manageable supply, healthy demand and stable credit outlooks should aid U.S. municipal bond performance in 2016 despite the Federal Reserve hiking interest rates, analysts and investors said.

While municipal bonds are ending 2015 on top of the fixed-income heap, some market analysts expect positive but smaller returns next year.

Tax-exempt bonds beat U.S. Treasuries and corporate and mortgage debt on Bank of America Merrill Lynch's master indices, with year-to-date total returns of 3.27 percent as of Dec. 17. Barclays' muni index returns as of Monday of 3.23 percent also outperformed every other U.S. and Canadian fixed-income index.

BofA believes munis can generate about 3.1 percent in returns next year, according to Philip Fischer, a municipal research strategist.

"We think the muni market is in good condition," he said.

Morgan Stanley's forecast calls for more-modest returns of 1.25 percent. However, Barclays' muni analysts project total tax-exempt returns to turn slightly negative at -1.0 percent to -0.5 percent in the coming year.

"Higher Treasury rates, rich valuations and headline risks are set to make 2016 a lackluster year for the municipal market," Barclays said in a Dec. 4 research note.

Last week's Fed rate hike and the promise of fatter yields could entice investors who have been sitting on the sidelines with cash to come back into the muni market.

"I think the odds are pretty good that the damage to munis specifically from (federal monetary policy) will be very modest," said Chris Mier, a managing director at Loop Capital Markets.

Yields on Municipal Market Data's benchmark triple-A scale are ending 2015 close to where they began the year, with 10-year bonds at 1.93 percent and 30-year bonds at 2.82 as of Tuesday.

But tax-exempt munis, which spent much of the year yielding more than comparable taxable U.S. Treasuries, were yielding less heading into 2016. The 10-year muni/Treasury ratio stood at 86.3 percent and the 30-year at 95.2 percent on Tuesday. Past periods of tightened monetary policy have lowered the ratio, signaling munis were outperforming taxable debt, according to analysts at Janney.

As of Friday, states, cities, schools and other issuers sold $376.6 billion of munis, 20 percent more than in the same period in 2014, with refunding volume outpacing new money issuance, according to Thomson Reuters data.

Projections for 2016 issuance range from $325 billion to $450 billion as still-low interest rates, even after the Fed's rate hike and an anticipated yield curve flattening, should continue to accommodate refundings, while pent-up infrastructure needs could spur an uptick in new money deals.

Nicholos Venditti, portfolio manager at Thornburg Investment Management, said supply may initially climb as the Fed rate hike could set off a scramble by muni issuers seeing their “last chance to issue at these incredibly low rates.”

Still, Dan Heckman, senior fixed-income strategist at U.S. Bank Wealth Management, foresees a “big issuance problem.”

“Refundings are increasingly going to dwindle,” he said. “It’s very hard to get ballot initiatives passed that might translate to new issuance.”

Demand remains strong with 11 straight weeks of hefty net inflows to muni funds as of the week ended Dec. 16, according to Lipper.

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