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What the Fed Rate Hike Means for the Municipal Market.

Short-term interest rates will be rising for the first time in nearly a decade, the Federal Reserve Board announced Wednesday. The move means mixed results for the states and localities that borrow money in the municipal market.

Citing "considerable improvement in labor market conditions this year," the board announced a scheduled rate hike of one-quarter percent starting in 2016. It would be the first of several small rate hikes, meaning interest rates could rise by more than 1 percent a year from now. In a statement, the Federal Open Market Committee said it is "reasonably confident that inflation will rise over the medium term to its 2 percent objective."

The move is a signal that the board believes the economy is strong enough to keep growing without as much help from the nation's central bank. The Fed slashed rates to zero — and has kept them there — following the 2008 financial crisis, in an effort to reboot the nation's economy. Now, as the fiscal outlook has continued to improve, this week's announcement was widely expected.

For those who issue municipal bonds, the rate hike has no immediate implications on any outstanding government debt. But it will likely place a slightly higher price tag on the cost of issuing debt in the coming year.

Still, many do not expect it to have a dampening effect on the municipal bond market as a whole.

For one, any government refinancing its debt will still be doing so at a significantly lower interest rate to generate savings.

Another big reason the rate hike will have a muted effect on the muni market is that the Fed's decision only impacts short-term interest rates, not long-term ones. In fact, sometimes a hike in short-term rates can actually cause a downward tick in long-term rates — saving money for governments that can afford to issue long-term debt.

For example, between 2004 and 2006, the Fed raised the short-term rate from 1 percent to 5.25 percent. During that time period, the rates on a 10-year Treasury bond only went up a half percentage point. And yields on the 30-year bonds actually went down slightly. The reason is because when short-term interest rates are increased, it actually dampens the impact of inflation, which is what plays the larger role in setting long-term interest rates.

"The expectation is the yield curve will flatten and influence the longer term much less," said Tim Barron, chief investment officer at Segal Rogerscasey. "So if you're refinancing a 20-year bond, it is likely to have very modest effects."

But the mere act of raising the rate, even though it was expected, does create a little volatility. That's because municipal investors will be closely watching to see how soon — and by how much — the Fed raises rates again. Another small step-up next year would signal that the economy is on track with expectations. A bigger hike would indicate a faster-growing economy. If there's not another rate hike, then it could be a sign of an economy that's slowing down again.

So, while the impact on government issuers remains to be seen, some entities will see more immediate benefits. Pension funds welcome a higher rate because it likely means more interest income will be generated from their bond investments, said Gail Sussman, managing director at Moody's Investors Service. The shift comes just months after pension funds reported they had meager earnings in fiscal 2015, due in part to poor returns from global public equities.

Housing finance agencies also benefit from the rate hike. They "will see higher profit margins, greater financing flexibility, and an opportunity to grow loan portfolios in a higher-rate environment," Sussman said.

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