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Rally in Longest Muni Bonds Drives Yield Gap to Eight-Year Low.

The longest-dated municipal bonds haven't looked this expensive since before the 2008 financial crisis. Yet investors aren't showing any signs of slowing their purchases.

Following a rally that began in the second half of 2015, the extra yield buyers pick up for holding 30-year debt instead of two-year securities fell last week to as little as 1.96 percentage points, the lowest since February 2008, according to data compiled by Bloomberg. The difference shows investors are anticipating that bonds maturing in decades will fare best at a time when inflation is subdued and the Federal Reserve is planning to raise short-term rates.

The so-called flattening of the yield curve has made a lot of people look prescient: Investors and analysts at more than half a dozen firms including Barclays Plc, Citigroup Inc., Janney Montgomery Scott and Morgan Stanley Wealth Management all predicted the move in December. Some say long bonds could extend the rally through year-end amid signs that individual buyers are no longer waiting for yields to rise from five-decade lows.

"We've come a long way in a few months, but going forward, munis can hold onto this flatness or flatten even further," said John Dillon, managing director at Morgan Stanley Wealth Management in Purchase, New York.

"Individuals have this greater comfort that long-term rates aren't going to get away from them, and they're getting the idea that reinvesting in two-year paper isn't producing any kind of return."

Even though the Fed raised its target rate in December for the first time since 2006, few expect significantly higher interest rates as other countries seek to combat a slowdown in growth. The futures market is factoring in a 6 percent chance the U.S. central bank will raise rates at its meeting in April, down from the one-fifth that was predicted a month ago.

On Monday, the Commerce Department reported that its price index for consumer purchases, a gauge closely watched by the Fed, dropped 0.1 percent in February from the month before, underscoring the lack of upward pressure on inflation.

For muni buyers in particular, the outlook is promising after weathering the usual wave of new bond offerings in March, which typically weighs on prices. States and cities issued $35.6 billion over the past month and the tax-exempt market gained 0.08 percent, according to data from Bank of America Merrill Lynch and Bloomberg.

"The long-end of the muni curve continues to look quite attractive, while the short-end should continue to cheapen," said Phil Fischer, head of municipal research at Bank of America in New York. "Continued curve flattening seems like a reasonable bet."

Individuals are speculating on the longest-dated debt outperforming. They've added money for 25 straight weeks to long-term muni mutual funds, which represent about two-thirds of overall tax-exempt fund inflows during the period, Lipper US Fund Flows data show.

Amid the demand, the yield on an index of benchmark 30-year munis is 2.73 percent, compared with 3.18 percent when the streak of inflows began, Bloomberg data show. By contrast, benchmark two-year rates, at 0.76 percent, are up from 0.56 percent, as traders price in another quarter-point Fed increase by the end of the year.

Not every investor is going all-in on the longest-maturing securities. Bonds due in eight to 12 years offer a better value for investors because prices haven't rallied as much, said Jamie Pagliocco, who oversees muni-bond funds at Fidelity Investments.

Yet even he sees the appeal of long-term debt for investors who are losing patience with muni-market yields that are stuck near the lowest since the 1960s.

"There can still be a fair amount of demand on the long end because of the absolute yield levels," said Pagliocco, whose company oversees $32 billion of munis. "The longer rates sit around this level, the more comfortable people get."

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