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Municipal Bonds Were Supposed to Get More Expensive in 2018. Why Didn't That Happen?

A widely followed municipal-bond index had its worst first quarter in 15 years

The first quarter is normally one of the best times of year to be a municipal bond holder. Not in 2018.

A widely followed municipal-bond index fell more in the first three months—1.11%—than any first quarter of the past 15 years. That is because new tax rules and concerns about rising interest rates are pushing down demand for new debt from state and local governments.

"We haven't seen prices drop this much in a long time," said Howard Cure, director of municipal bond research at Evercore Wealth Management.

The last time the Bloomberg Barclays Municipal Bond Total Return Index dropped for the entire first quarter was in 2008.

Bond values usually jump in the first few months of the year as investors look to reinvest cash from stock gains and maturing bonds. Prices were expected to again follow that pattern this year due to limited supply.

But this time, demand turned scarce early in the year, partly because Congress late last year passed new legislation lowering tax rates, making tax-exempt bonds less appealing for banks and insurance companies that traditionally hold a large chunk of the nation's municipal debt. The tax rates paid by these institutions fell to 21% from 35%.

"With the lower corporate tax rate, there is less incentive for banks and property and casualty companies to buy munis," said Vikram Rai, Head of Municipal Strategy at Citigroup.

At the same time, individual investors became wary about the prospects for inflation and higher interest rates. Inflation undermines the value of outstanding bonds in part by reducing the purchasing power of their fixed payments, and rising rates make newly issued bonds more appealing than outstanding bonds with lower coupons, driving down their prices. Federal officials in March raised interest rates and are forecasting two more rate increases in 2018.

The low bond prices have driven up borrowing costs for state and local governments that have issued debt in recent months. The state of Maryland, for example, is paying yields of 2.54% on 10-year general-obligation debt issued in March. That is up from 2.49% on 10-year general-obligation debt sold in March 2017. These bonds typically pay for schools, hospitals and other public projects.

To be sure, mutual-fund investors did buy bonds in January as nearly $6 billion flowed into municipal-bond funds, an uptick analysts attributed to efforts to rebalance portfolios following stock gains. That is 58% above the average for the past five first quarters.

But in February and March, investors put $268 million into municipal-bond mutual funds, according to Lipper data. It was the lowest inflow for the period in the past five years and a 92% drop from the five-year average for the first quarter.

“Investors may want to sell but most buyers would rather wait and see what happens,” said Patrick Luby, senior municipal strategist at CreditSights.

Some bonds bucked the pricing trend: Municipal debt tied to Puerto Rico increased in value during the first quarter because of investor hopes that the island would recover more quickly from Hurricane Maria than previously expected.

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By Heather Gillers

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