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The Muni-Market's Terrible, Horrible, No Good, Very Bad Year.

- **Falling sales squeeze underwriters while investors see losses**
- **'It's a bumpy time when rates are going up," investor says**

This year is turning out to be one many in the municipal-bond world would rather forget.

Thanks to a federal tax-overhaul that caused a rush to borrow last year and curbed governments' ability to refinance debt, new bond sales have shrunk by 20 percent, cutting deeply into underwriting fees. Trading is down. Demand has dropped from some of the market's major buyers, banks and insurers, because tax rates were lowered. And with interest rates headed higher, the securities have handed investors a loss of 1.4 percent, marking the worst start to a year since 1996.

"We have been stuck in such a low interest rate environment for so long," said Ross Maynard, director of client portfolio management at Ascent Investment Partners, which holds about $500 million of municipal securities. "We always knew the transition period wasn't going to be comfortable. I think we're very much in that right now."

The municipal market isn't the only one whipsawed by worries about tighter monetary policy, and tax-exempt debt has posted smaller losses than corporate bonds or Treasuries, thanks in part to the drop off in supply. Moreover, higher yields will eventually draw in investors, whose returns have been restrained by a decade of low interest rates.

But for now, that may be little consolation, with investors pulling money out of municipal mutual funds for the past four weeks. Firms including Piper Jaffray Cos., Raymond James Financial Inc. and the Royal Bank of Canada said their investment banking divisions have also been hit by lagging debt sales in the first quarter.

"If rates are going up and good-quality municipals are giving 4 percent or more in tax-free cash flow, over the long term that's going to be good for people in high tax brackets," said Jim Pratt-Heaney, chief investment officer at Coastal Bridge Advisors in Westport, Connecticut. "It's a bumpy time when rates are going up."

Analysts say the market may be bolstered in the next few months as the amount of money investors receive from maturing debt and interest payments outstrips the supply of new bonds. That augurs well for demand, given that bond payments are frequently reinvested. Over the next month, some $9.3 billion of municipal debt is set to be sold, far less than the $19.7 billion bondholders will get from securities that are being paid off, according to data compiled by Bloomberg.

Ascent's Maynard, like many investors, is buying shorter-dated debt, which is less sensitive to interest-rate changes and is one of the few niches to deliver positive returns. He said it's a fools errand to try to predict which way the market will shift over the near-term — given that bullish analyst forecasts for January proved off base.

“You might as well be at the craps table,” he said.

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