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Yield Curve Distorted by Fear in Tax-Free Muni Bonds.

Not all fixed-income investors are getting that flattening feeling.

By now, anyone who pays attention to financial markets has been inundated with reports about the flattening Treasury yield curve. The historical predictor of U.S. recessions is starting to flash signals that the economic recovery is getting long in the tooth.

But it seems as if the $3.8 trillion market for U.S. municipal bonds, a close cousin to Treasuries, missed the memo.

In fact, the difference in the slope of the two markets' yield curves is almost as large as it has ever been. In munis, 10-year AAA bonds yield about 85 basis points more than two-year obligations. For Treasuries, that gap is 25 basis points. Aside from a fleeting moment after the financial crisis, that spread is the widest since the U.S. yield curve was inverted in early 2006.

This oddity would seem to suggest that either the Treasury curve is too flat, munis are too steep, or that something is different this time that justifies the divergence. I tend to think it's the latter, with the culprits being the different buyer bases for the two fixed-income assets and years of ultra-loose monetary policy that distorted global debt markets.

There are a lot of sophisticated investors in the $15 trillion market for U.S. Treasuries. They include China, which oversees $3.1 trillion in foreign-currency reserves; Japan's Government Pension Investment Fund, the world's biggest retirement fund at $1.43 trillion; and any number of hedge funds and investment managers in the United States. Speculators can easily bet on a market sell-off by shorting futures contracts, and they've done so more than ever.

To put it bluntly, that just doesn't exist in the municipal market. There are no muni futures contracts. Many investors buy the bonds and hold until maturity, using the tax-free interest as a bedrock of their overall portfolio. Overseas investors don't benefit from the tax exemption, so the lower absolute yields are generally not enticing relative to sovereign debt or corporate securities.

This dynamic allows for a fear factor to creep in, helping explain the diverging yield curves. With the Federal Reserve raising interest rates six times in the past 20 months, it's only natural for "mom and pop" investors to wonder whether they're going to suffer losses on their fixed-income funds or individual holdings. It doesn't help that some market commentators have made headlines by warning of an impending "bond bear market."

As muni investors learned all too well during the "taper tantrum" in 2013 and after Meredith Whitney's incorrect forecast of "hundreds of billions of dollars" of defaults in the coming year in December 2010, those types of ominous outlooks can rattle the denizens of the tax-exempt market. Sure, funds aren't experiencing outflows as they did during those periods. But the refusal of long-term yields to come down speaks to the angst over extending portfolio durations, Barclays Plc strategists said last month. It's no wonder that Morningstar Inc. recently found that individual investors were more skittish in munis than any of the eight asset classes they examined.

It’s not as if Wall Street is oblivious to this yield-curve decoupling. Barclays says 10-year munis have more value than shorter-dated debt. So does Tom Kennedy, head of fixed-income strategy at J.P. Morgan Private Bank. Here’s what he said in a Bloomberg Radio interview last week.

“The municipal market is actually looking quite attractive. In the front end, we don’t see it in your favor, but further out in the municipal curve, there’s actually a steepness in that curve. The muni yield curve is actually quite steep. So if you move further out to 10-year muni bonds, you can actually pick up 100 basis points.”

It’s worth noting that the tax-exempt yield curve never inverted before the previous recession, with the spread between two- and 10-year debt falling only to as low as 15 basis points in February 2007. Again, that speaks to the more buy-and-hold mentality. Conceptually, it’s hard for investors to wrap their minds around getting paid less to sock money away for 10 or 30 years than for two or three.

By contrast, inversion is seen as practically inevitable for Treasuries. That’s because corporate pension funds seeking to match their liabilities are snapping up long bonds in any sell-off, keeping the 30-year yield stuck below its year-to-date high. It also helps that yields in Europe and Japan remain suppressed by their central banks. Meanwhile, with traders fully on board with the Fed’s rate-hike plans, shorter-term yields keep climbing. And because futures give speculators the ability to bet that yields rise further (and prices sink), there’s no support for that segment of the market.

It’s gotten to the point that two-year munis were about the most expensive relative to Treasuries in recent history last month. The two-year tax-exempt yield on July 26 was 1.62 percent, while the two-year Treasury note yielded 2.68 percent. The ratio of the two fell to 60 percent, a steep departure from the 115 percent average since the start of 2009.

All signs suggest municipal-bond buyers should purchase longer-dated securities if they’re in the market for new investments. But no one has ever experienced a true Fed tightening cycle after years of keeping short-term rates near zero and multiple rounds of quantitative easing. It’s entirely possible that what appears to be a distortion is actually the natural response to the central bank’s actions. And munis lack easy ways to arbitrage away the difference.

That leaves it up to mom and pop to confront their fears and go long. Even though the “bond bear market” has hardly been devastating this year, those skittish tendencies may be too much to overcome.

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