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The New Tax Law Is Making Waves in Municipal Bonds.

Most tax-exempt municipal bonds have become pricey this tax season. But the opposite has happened in the market for short-term municipal debt.

That market's weekly benchmark interest rate rose by the most since the financial crisis last week, as investors pulled cash from muni money-market funds to pay their tax bills.

The back story. Municipal governments can borrow at floating short-term rates by issuing variable-rate demand notes, or VRDNs. Those notes are effectively daily or weekly loans, and usually are backed by banks. (VRDNs actually have long maturities, but because they allow investors to get their money back on a daily or weekly basis, money-market funds can own them.)

The differential between VRDN yields and other U.S. interest rates has hardly moved since the financial crisis. Back then, the benchmark for that spread—the Sifma Municipal Swap Index—soared by 3.36 percentage points in the span of a week.

What's new. The Sifma index rose by 0.5 percentage points in the week ended Wednesday. That is the largest increase since the week ended Sept. 24, 2008, when the index rose by 2.81 percentage points.

That increase wasn't entirely unexpected; tax season usually puts pressure on the VRDN market. Because VRDNs offer daily and weekly opportunities to withdraw money, individual investors often sell them when they need cash fast, pushing prices down and yields up.

And last week was the deadline for Americans to file their returns for the first time under the new U.S. tax law. While it isn't yet clear whether taxes went up or down for most Americans, state and local taxes went up, and some advisers say their clients were surprised with tax bills.

Indeed, investors withdrew \$4.5 billion from tax-exempt money market funds in the week ended Wednesday, according to Lipper, following a \$1.8 billion outflow the week before. Banks were left with large inventories of VRDNs on their balance sheets as a result, according to a note from Citigroup .

Looking ahead. It won't be long before yields on VRDNs return to levels that are closer to other U.S. interest rates, analysts say. Barclays expects the Sifma index will keep rising through the end of April, and then return to normal.

That is because investors typically receive a large amount of cash from muni-bond coupon payments in May, June and July. That extra cash will probably find its way into the VRDN market. After all, the fixed-rate municipal bond market is looking expensive.

Barron's

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