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Municipal Bond Market Starts the Year Strongly.

The municipal bond market is starting 2021 on a strong note amid robust demand, light supply of new issues, and expectations of fiscal relief for state and local governments as well as potentially higher income taxes with full Democratic control in Washington.

A key indicator of tax-exempt bond demand, the yield ratio of 10-year triple-A munis relative to the 10-year Treasury note, stands at 66% and is at its lowest level in 20 years. The ratio began the year at around 75% after peaking at over 200% during the market turmoil last March. It has averaged close to 100% over the past 20 years.

The current ratio means that even investors in the top 37% federal tax bracket are getting little benefit to owning munis relative to Treasuries.

Muni yields have barely budged this year as Treasury yields have risen. The 10-year AAA muni now yields about 0.75%, against 1.11% for the 10-year Treasury, according to Bloomberg data.

New-issue volume so far in 2021 has been about \$3 billion, about half the pace of the weekly pace of 2020.

One portfolio manager tells Barron's that demand is strong as bondholders reinvest Jan. 1 interest payments and as investors anticipate relief from Washington for strapped municipal-bond issuers and the possibility of higher federal income taxes, which would increase the appeal of munis relative to Treasuries and other taxable debt.

"The Biden administration's policies are expected to positively impact the municipal market in multiple ways," wrote municipal-bond managers at MacKay Shields in their 2021 outlook. "Anticipated initiatives include infrastructure spending, increasing employment opportunities and addressing climate change."

"In addition, investor anticipation of the Biden administration pushing taxes higher (more likely a 2022 event) increases the value of tax exemption and municipal demand," the managers added.

Barron's took a cautious view of the municipal market in our 2021 income outlook, arguing that yields were historically low on an absolute basis and relative to Treasuries. Many municipal bonds yield less than inflation running at 1.5% to 2% and with Treasury investors banking on 2% annual inflation in the coming decade.

The MacKay Shields managers are more upbeat:

"We believe that tax-exempt bonds from municipal issuers providing essential services will outperform other fixed-income asset classes due to their favorable, intrinsic credit characteristics. While we understand municipal bond investor uncertainty is due to weak economic conditions, low yields and negative news coverage on the sector, investors should focus on what we believe is the inherent stability of municipal revenue streams sourced from municipal services that are essential to our everyday lives."

Bonds issued by risky issuers like the Metropolitan Transportation Authority, which operates New York's subway system, have rallied lately as investors bet on more federal aid. The MTA's 5.25% bonds due in 2055 now yield 2.45%, down from 5% in the spring.

The MacKay Shields managers see opportunity in the potential restructuring of about \$11 billion of Puerto Rican debt in 2021 following the successful restructuring of Puerto Rican sales tax revenue bonds known as Cofina.

"We believe that the long-awaited final chapters in the restructuring of Puerto Rico debt will provide investors an attractive relative value opportunity in the territory's credits," the MacKay managers wrote.

Barron's

By Andrew Bary

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