U.S. Muni Market Ignores Stimulus-Provoked Rise In Treasury Yields.

CHICAGO, Jan 13 (Reuters) – Expectations that more fiscal stimulus is coming under a Democratic-controlled White House and U.S. Congress are further eroding the historically close correlation between U.S. Treasury yields and those on municipal bonds.

Longer-term yields in the $20 trillion market for U.S. government debt have soared to levels last seen in March, while yields have barely budged in the $3.9 trillion market where states, cities, schools and other issuers sell bonds.

Treasury yields jumped on prospects that new stimulus will boost growth in the coronavirus-battered economy and also increase Treasury supply after Georgia runoff elections for two U.S. Senate seats last week gave Democrats narrow control of Congress.

For munis, a supply and demand imbalance along with President-elect Joe Biden's willingness to send billions of federal dollars to states and local governments dealing with pandemic-related revenue losses have kept yields in check.

Andrew Richman, senior fixed income strategist at Sterling Capital Management, said stimulus prospects have lifted prices and lowered yields for debt from financially troubled issuers like Illinois, while the muni market has grown more attractive for investors on the assumption that taxes will go up to pay for increased federal spending.

"That makes the desire for munis even greater," he said. "Even though valuations are not great, it's the one place to get tax-free income."

Muni yields are typically lower than those of comparable Treasuries because interest income earned on munis is exempt from federal and sometimes state taxation.

Municipal Market Data's (MMD) ratio of top-rated 10-year tax-exempt muni bond yields to comparable taxable Treasury yields this week neared an all-time low of 65.25% reached in 1984. It was last at 72.6%, indicating that munis are much more expensive relative to the federal government's debt.

"That's how out of whack we are right now relative value-wise," said Greg Saulnier, MMD's managing analyst.

The ratio went to the other extreme last March as the coronavirus pandemic began to upend economies, rising to as high as 369.54% when a selling frenzy hoisted muni yields dramatically until the U.S. Federal Reserve stepped in with emergency measures to backstop financial markets.

The 10-year yield on MMD's benchmark triple-A scale, which began 2021 at 0.720%, ended Wednesday at 0.790%. By contrast, the 10-year Treasury yield jumped from 0.9170% on Jan. 4 to as high as 1.187% on Tuesday before retreating a bit on Wednesday.

Cooper Howard, director of fixed-income strategy at the Schwab Center for Financial Research, said a supply/demand imbalance has put a cap on muni yields.

“There’s been little amount of supply coming into the market lately and there’s continued inflows into bond mutual funds and (exchange-traded funds),” he said.

He added that muni yields could rise once supply increases.

After issuance hit a record $451.2 billion last year, supply has been slim so far in 2021 at the same time investors have money from January coupon and principal payments to plow back in to the market.

Saulnier said “everyone’s expecting free-flowing stimulus from the Democrats,” noting that states like New York and Illinois could get “a huge amount of help.”

Citing a $15 billion budget gap, New York Governor Andrew Cuomo on Monday said the federal government “must deliver fairness for New York and they must do it quickly because our budget is due April 1.”

In recent weeks, investors snapped up high-yielding Illinois general obligation bonds, narrowing the punishing spread for the state’s 10-year bonds over MMD’s scale from as wide as 314 basis points in November to 120 basis points on Wednesday.

With no new funding from Washington to address a budget gap, Illinois, the lowest-rated state at a notch above junk, was one of only two governmental entities to tap the U.S. Federal Reserve’s Municipal Liquidity Facility, borrowing a total of $3.2 billion.

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