Why the Muni Bond Market Could See a Correction Soon.

A robust municipal bond market could be vulnerable to a modest correction after besting most other areas of the fixed-income markets so far this year.

Peter Hayes, the head of the municipal bond group at BlackRock, noted that the muni market was showing positive year-to-date returns of about 0.6% through early this week, based on the S&P Municipal Bond Index, against returns of negative 2.5% to 3% for some major taxable-bond indexes.

Munis have been buoyed by modest supply and strong demand from retail investors, who have added $28.8 billion to muni funds in 2021, according to data from the Investment Company Institute.

"With all this demand and low supply, our relative valuation, how we look against other fixed-income asset classes, is not as attractive," Hayes told Barron's. "Retail investors really don't look at that, but nevertheless we are pretty rich on that basis. We expect a little bit of a correction to take place over the next month or two."

Benchmark triple-A 10-year muni bonds are yielding 0.92%, just 60% of the 10-year Treasury note. That ratio, which got as tight as the low 50s in February, has averaged in the 80% to 90% area for the most of the past few years, excluding the dislocations of last March.

Hayes doesn't think the current ratio is sustainable over time. "At 70% to 75%, the market would feel a lot healthier," he said.

Top federal income-tax rates are now 37% and potentially going higher. But even if taxes do go up, munis would offer little appeal relative to Treasuries. Most munis yield more than top-tier, triple-A bonds.

"We think there are some better opportunities ahead; we're keeping some cash on the sidelines," Hayes said. "We think rates need to go modestly higher and there could be better opportunities for people to enter the muni market."

There is more yield below the triple-A tier, with double-A-rated long-term California general-obligation bonds yielding about 2.45% this week, slightly above the rate on the 30-year Treasury bond.

Muni credit fundamentals are in excellent shape, Hayes said, reflecting better-than-expected tax revenues and federal aid.

Hayes noted that there was a lot of discussion in 2020 about the impact of the pandemic. "The reality is that municipal credit has fared very well. The budgets deficits that had been predicted are turning into surpluses. We're more positive on credit than we were six to nine months ago."

BlackRock favors bonds from higher-quality state and essential-service revenue bonds as well as those issued by top universities. The firm is underweight on senior living and long-term care facilities.

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