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Munis Head for Longest Slide Since 2016 on Sign of Ebbing Demand.

- **3-month drop comes as state, local mutual funds draw less cash**
- **Analysts point to impasse in D.C. on spending plans, tax hikes**

Municipal bonds are headed for a rare three-month slide, joining a broad slump in the U.S. debt market, amid signs that the insatiable demand that's buoyed tax-exempt securities this year may be waning.

Muni mutual funds collected $385 million of cash in the week ended Oct. 13, according to Investment Company Institute data. That was the second-smallest haul since March, and it compares with the $1.9 billion weekly average for 2021. What's more, municipal exchange-traded funds saw an outflow for the first time since February, CreditSights data show.

It's a possible indication that muni investors may be tiring of waiting for lawmakers in Washington to hammer out new spending measures that include tax increases on wealthy Americans. The expectation of such legislation has been a key driver behind the influx of cash into municipal debt this year, fueling the market's outperformance relative to Treasuries.

"Some of the slowdown in mutual fund flows may be due to seasonal factors, but because flows into muni ETFs have also slowed in the past two weeks, we think that there is a partial shift in market sentiment occurring," wrote Patrick Luby and John Ceffalio at CreditSights in a Monday research note.

The lackluster demand combined with rising Treasury yields have munis on track to lose 0.4% in October. It would be the third straight monthly decline, the first time that's happened since late 2016, according to Bloomberg index data. It's not as rare an occurrence in Treasuries, which are on the cusp of a similar slump and also suffered a four-month losing streak from December through March.

The appetite for munis may falter further should expectations for higher tax rates not materialize, said Matt Fabian, a partner at research firm Municipal Market Analytics.

"Congressional Democrats are finding those hikes to be difficult to implement," Fabian and colleague Lisa Washburn wrote in a note dated Monday.

'More Value'

Some money managers are finding a silver lining. Nisha Patel at Parametric Portfolio Associates LLC said the softening market has created a buying window for the ample amount of cash waiting on the sidelines.

"We saw a bit more value than what the new normal has been as of late," she said. "It's as exciting as it's been in a little bit of time."

Of note, municipals are still up for 2021, earning 0.4%. That's better than U.S. Treasuries, which have lost 3% this year as elevated inflation has led investors to bring forward bets on when the Federal Reserve will starting lifting borrowing costs.

"If you pull money out of munis, where are you putting it?" Patel said.

There's another way to gauge the opportunity created by the selloff. Relative to Treasury yields, muni rates are close to a seven-month high. That ratio hovered near all-time lows for months in 2021 as cash poured into tax-free debt.

"We reached a point where it was logical to have a bit of a pushback," said James Iselin, head of the municipal fixed-income group at Neuberger Berman Group. "We need higher yields, we need ratios for high-grade bonds to be more attractive, all those things are healthy for the market."

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By Danielle Moran

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