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Munis' Worst Annual Start Since 2001 Imperils 'January Effect'

- **Market's 10-year average January return, 0.9%, trails only May**
- **Fed throws 'monkey wrench' into January dynamic: Lanouette**

The municipal-bond market's worst start to a year since at least 2001 is marking a major departure from what has historically been a period of strength for the securities.

State and local debt has sold off along with the rest of the bond market in the early days of 2022, losing 0.7% last week, according to Bloomberg indexes. That comes as traders are absorbing the possibility that the Federal Reserve will start hiking interest rates as soon as March amid elevated inflation.

While munis are down less than Treasuries to start the year, the weakness in state and local debt is imperiling munis' so-called January effect, when seasonal tailwinds usually support bond prices. The muni market's 10-year average return in January, of 0.9%, trails only May, Bloomberg index data show. At this time of year, muni issuance is typically light and an uptick of coupon and principal payments to investors fuels demand as they look to reinvest that cash.

"The Fed has thrown a monkey wrench into the whole January effect," said Christopher Lanouette, a managing director for CIBC Private Wealth Management. He said he's reducing exposure to the 8- and 10-year part of the muni curve to prepare for rising rates.

January's seasonal impact may still be shielding municipal debt. State and local debt extended its selloff on Monday, with yields on the 10-year AAA benchmark rising to 1.2%, the highest since November. However, 10-year Treasury yields have surged to levels last seen in January 2020.

Investor demand will be crucial to assess how municipal performance will hold up should the fixed-income pain continue. Analysts have warned that inflows into municipal-bond funds could slow, especially if interest rates keep rising.

So far, there's no major sign of demand ebbing. Investors added about $841 million to muni mutual funds during the week ended Wednesday, marking 44 straight weeks of gains, according to Refinitiv Lipper US Fund Flows data.

$1 Billion for Bid

Last week showed increasing signs of selling pressure, with investment managers putting $1 billion of securities out for bid on Jan. 6, the highest since February, according to data compiled by Bloomberg.

Kim Olsan, senior vice president of municipal bond trading at FHN Financial, said the volume of bids-wanted is higher than usual in January, when demand is typically high. The market's rich valuations relative to Treasuries have "put generic yields more on the defensive than is customary so early in the month," she said in a note Monday.

"It's been an unusual start to the year for municipals," she said.

Citigroup Inc. strategists led by Vikram Rai said in a note Monday that there could be "rocky times" ahead for the market, and that it could see outflows from muni funds.

"We may be nearing the cusp of a fund outflow cycle and if we witness another 20-25bp sell-off in Treasury yields before month-end, it might be enough to trigger it," they said.

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