
Pimco Sees Munis as Haven From Bond-Market Pain as Fed Hikes.

- **Munis tend to outperform during tightening cycles, Hammer says**
- **The debt's tax-free interest boosts its appeal, manager says**

Pacific Investment Management Co. expects municipal debt to offer a bond-market haven from rising interest rates, a view that's already bearing out amid an ugly start to the year for fixed income.

Ten-year Treasury yields climbed on Thursday to the highest since April 2021 as traders bet the Federal Reserve will hike its benchmark rate as soon as March to restrain inflation. U.S. government debt has lost 1.3% this week, on track for its worst stretch since 2020, while munis have only dropped 0.2%, Bloomberg index data show.

The municipal market has a history of outperforming during periods when the Fed hikes rates, according to David Hammer, head of municipal-bond portfolio management for the firm, which oversees more than $76 billion in state and local-government debt. That's because as yields rise, the tax-free interest that munis pay makes them more attractive, he said in an interview.

"It's this dynamic that historically has caused tax-exempt muni spreads to tighten relative to other taxable fixed-income investments as rates rise," he said. "The muni market has a long history of outperforming as interest rates rise."

It's a track record that will likely be put to the test in 2022. At their December meeting, Fed officials were anticipating three quarter-point hikes in 2022. The bond market got a jolt Wednesday after the minutes from that gathering showed policy makers considering earlier and faster rate increases than previously expected.

During the last Fed tightening cycle, which began in December 2015 and lasted until December 2018, investment-grade municipals returned over 7%, while U.S. Treasuries earned about 4%, Hammer said.

The muni market showed its haven potential in 2021, attracting a flood of cash and beating the rest of the bond market, thanks in part to demand fueled by debate over federal tax hikes.

Junk's Appeal

For Hammer, junk-rated munis have also outperformed when rates rise. That segment of the muni market is benefiting from improving credit conditions for issuers, which has kept defaults low. It also offers elevated yields compared to high-yield corporate bonds after accounting for taxes, he said.

"High-yield munis still look attractive," Hammer said. "We see this as a defensive position if the economy was to disappoint."

Hammer favors structures like floating-rate notes, a type of short-term debt with a coupon that is benchmarked off short-term indexes like the SIFMA Municipal Swap index.

When the Fed raises rates, it will cause the coupon that the securities pay to drift higher, while prices typically trade around par. He’s avoiding longer-dated securities that are more sensitive to rising rates.

Bloomberg Markets

ByAmanda Albright

January 6, 2022