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Muni Bonds Log Worst Start to the Year Ever as Fed Gets Set to Hike Interest Rates.

Analysts expect the market to find some equilibrium soon

The municipal bond market is having the worst start to any year on record, as market participants brace for the Federal Reserve to hike interest rates and investors shy away from bonds that had grown too expensive and yielded too little given the risk.

The Bloomberg Municipal Bond Index has lost 2.5% so far this year, its worst performance ever. Plus, $5.8 billion has flowed out of municipal bond funds, according to Refinitiv Lipper data.

But muni analysts think a pullback is to be expected after the heated demand of last year. Most expect the asset class to fare better than others, once through the initial choppiness.

“Munis were the best of the fixed-income buckets to be in last month,” said Eric Kazatsky, head of municipal strategy for Bloomberg Intelligence, whose data are shown below. “There weren’t a lot of places to hide in fixed income in January.”

It’s a sharp contrast to 2021, which saw investors clamor for municipal bonds so aggressively that weekly inflows smashed records throughout the year. That demand was buoyed by investor confidence in state and local borrowers, which received ample federal stimulus. For their part, municipal issuers with cash on hand saw little reason to sell debt, which kept supply lean.

Those “incredibly rich valuations with low yields” made investors more wary by the turn of the year, said Justin Hoogendoorn, head of fixed income strategy and analytics at Hilltop Securities, and with the central bank signaling it’s turned more hawkish than many market participants had expected, the muni market was ripe for a sell-off.

Bond yields fall as prices rise.

But in past rate-hike cycles, the muni market has traditionally outperformed the Treasury market. “Munis are often viewed as a bit of a defensive vehicle,” Hoogendoorn told MarketWatch.

A key metric to watch is how much a typical municipal bond yields versus a comparable Treasury note TMUBMUSD10Y, 1.917%. On Monday, that ratio, of 10-year securities, was at 75%. As it starts to climb and munis become more attractive —likely around the 80-85% threshold — additional buyers will flood into the market, Hoogendoorn predicts.

Kazatsky thinks some investors might be more cautious. “No one wants to catch a falling knife when it comes to how high rates are going to go,” he said in an interview. Still, he noted, muni bonds are the only option for investors looking for tax-exempt income.

So far, higher rates haven’t had much of an impact on issuance this year. Bloomberg data show the volume of paper coming to market has fallen about 6% compared to the same period in 2021. Still, the muni market is made up of thousands of individual jurisdictions, and issuing bonds at even a slightly higher rate than expected can be uncomfortable for local governments and taxpayers.

MarketWatch

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