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Fresh Ideas for Borrowers in an Unstable, Two-Faced Muni Bond Market.

Tax-exempt issuers' costs have shifted upward dramatically this year as the Federal Reserve has pushed interest rates higher to fight inflation. It's time to re-strategize debt management programs.

Bond and stock market pundits just can't stop talking about this past year's rapid escalation of interest rates from the artificially low levels that prevailed through most of the COVID-19 pandemic. It seems most traders have amnesia and cannot remember a time when prevailing interest rates were anything close to previous, historically higher inflation rates. The talking heads keep reacting as if the trough in interest rates during the 2020-2021 pandemic period was timeless. That's called "recency bias."

Although the Federal Reserve's "tightening" actions have pushed money market rates higher, short-term municipal bond and note yields — returns to investors — still remain far below prevailing inflation rates. Yet tax-exempt munis with maturities over five years continue to yield more than taxable Treasury bonds and the market's expected rates of future inflation, making their after-tax returns to investors — and their inflation-adjusted costs to borrowers — higher than public-finance textbooks would predict. It's a two-faced market in muni-land.

Clearly, the muni market faces an unstable period for the next 12 to 24 months, first as Fed tightening continues, then while inflation rates hopefully subside, and then as the U.S. economy teeters between a soft landing and a recession scenario that could compel another round of lower interest rates. Once again, debt managers and financial advisers face novel market and economic uncertainty as they map out their plans for capital projects, cash-flow borrowing and long-term debt management.

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