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Fed Rate Policy Is Shaking Up the World of Muni Debt.

Demand is down for municipal bonds, which have erased nearly all of their January gains

The markets' bumpy start to 2023 is causing whiplash even in the historically placid realm of state and local government debt. Municipal bonds this month have erased nearly all of their January gains after fears of rate increases cooled investor appetites.

"It has been a roller coaster," said Nathan Will, head of municipal credit research at Vanguard Group.

Muni fund inflows topped $1 billion a week for most of January, according to Refinitiv Lipper. They have slowed in February after strong sales and jobs data sparked mounting concerns that the Federal Reserve will continue to increase rates for the foreseeable future. In the week ended Wednesday, investors yanked more than $1.6 billion.

Their concern has blossomed just as a flurry of new bonds hit the market, pushing up supply. After weeks of lower-than-usual borrowing by state and local governments, New York City sold $677 million in muni debt this week on the heels of a nearly $2.5 billion bond sale by the University of California system.

"You had demand getting a little bit slower with supply picking up at the same time. That put some pressure on the market," said Daniel Solender, partner and director at the investment company Lord Abbett.

The year-to-date total return on the Bloomberg Municipal Bond Index was 0.55% as of Thursday, down from 2.87% at the end of January, according to FactSet. Measured daily, the total return has zigzagged just this year between a high near 0.6% and a low of negative 0.6%. Total return is the return on the bonds including price changes and interest payments.

The prospect of rising rates tends to push down bond prices because newly issued higher-interest debt makes outstanding lower-interest bonds less attractive. That is why munis, along with other bonds, suffered their worst year in decades in 2022 as rates climbed.

Most bonds in the $4 trillion muni market are backed by state and local taxes, and prices for the ultrasafe securities tend to move in line with Treasurys. Demand rarely flags because the bonds have a perk coveted by high-income investors: Interest is generally exempt from federal and state taxes. A tax-free yield of 5% equates to a taxable yield of around 8% for investors in the top tax bracket, according to data from Nuveen Asset Management.

But after more than a year of investors and traders trying to predict what the Fed will do, heads are spinning even in the muni market. Over the past two months, debt maturing in one year has been trading at higher interest rates than debt maturing in three years, according to ICE Data Services. Market professionals say they can't remember that happening for such a prolonged period in more than a decade.

A so-called inverted yield curve, when short-term rates dwarf longer-term ones, is often seen as a sign of an impending economic slowdown when it appears in the Treasury market. In the muni market, where short-term securities are prized for their tax-exempt income, it is also a sign of confusion, said Municipal Market Analytics partner Matt Fabian. Like other investors, muni bondholders are trying to interpret a barrage of conflicting signals.

“All this volatility has bent the muni market a little bit,” Mr. Fabian said.

Adding to the turmoil is a standoff in Congress as the U.S. approaches its borrowing limit.

“We’re seeing the debt ceiling debacle shake muni markets,” Amanda Hindlian, president of fixed income and data services at ICE, said this week. Republicans are calling for any increase in that limit to be paired with spending cuts, a path that could reduce federal funding for state and local governments.

State and local governments are already under budget pressure from rising interest rates, higher costs for goods and services and the possibility of a sustained economic slowdown. But federal aid and robust tax revenues from the stimulus-fueled pandemic recovery have created a strong financial cushion. Fitch Ratings deems the outlook for most state and local government bonds stable going into 2023. The firm upgraded New York City ahead of its bond sale this week, despite projected budget deficits and work-from-home-related revenue struggles.

Still some managers worry that muni prices don’t fully reflect the possibility of a prolonged recession, particularly for the roughly half-trillion dollars in speculative-grade and unrated muni bonds that finance more risky ventures such as museums, charter schools and economic development projects.

“You’re not getting paid enough in our view to take that risk on right now,” said Duane McAllister, senior portfolio manager with Baird Advisors.

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By Heather Gillers

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