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Taking Advantage of an Anomaly in the Municipal Yield Curve.

An unusual inversion in the municipal-bond yield curve has resulted in attractive yields in short-dated issues. One compelling opportunity in this environment: municipal bond ladders.

The shape of the U.S. Treasury curve gets a lot of attention. Since yields on two-year notes moved above those of 10-year notes in early 2022, it has been hard to miss the deluge of headlines regarding the relevance and various implications of the inverted Treasury yield curve. What rarely gets much attention, however, is the municipal-bond yield curve.

A distinguishing characteristic of the municipal yield curve has been its consistent upward slope, with 30-year bonds always offering higher yields than short-term bonds. Several factors have contributed to this enduring steepness (as discussed in this Market View), especially certain behavioral biases among bond issuers and muni buyers. Much of municipal bond supply is in longer maturities, while a significant portion of the demand gravitates toward the shorter and intermediate parts of the curve, especially from individual investors, who are the predominant buyers of municipals. This tends to result in excess demand on the short end and higher yields at the long end. Over longer-term holding periods, those higher yields have translated to higher total returns in longer-maturity bonds.

Despite some flattening over the last year, the municipal curve has retained its upward slope between the two-year and 30-year maturity range — a stark contrast to the Treasury curve, which is inverted by roughly 100 basis points when measured both between the two-to-10-year, and the two-to-30-year maturity range. What is unique about today's environment, however, is that the two-to--0-year segment of the municipal yield curve inverted for the first time in history and has remained so for several months.

Continue reading.

Lord Abbett

By Stephen Hillebrecht, Nicholas Bragdon

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