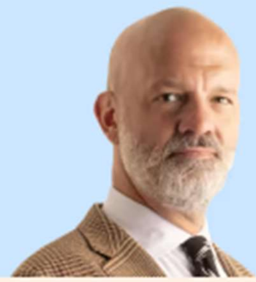
Opinion **Unhedged**

Muni bonds are suddenly not boring

And still more on inverted curves

ROBERT ARMSTRONG ✓ Added



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Good morning. We got lots of lively responses to our debate with Adam Tooze about China's future. Several critical readers argued that sceptics on China's unbalanced economic model (such as Unhedged) have been around for years, and have been proven incorrect year after year. This is wrong, though. Those who have predicted falling growth, spiralling debt, and financial crises in China have been proven right: those things are exactly what we have seen in the past few years, culminating with the Evergrande smash-up. And all of this is acknowledged by Chinese officials, for example in the readout from the Central Economic Work Conference. Unhedged's sceptical view of Chinese growth is nothing more or less than the view that what is happening now will keep on happening.

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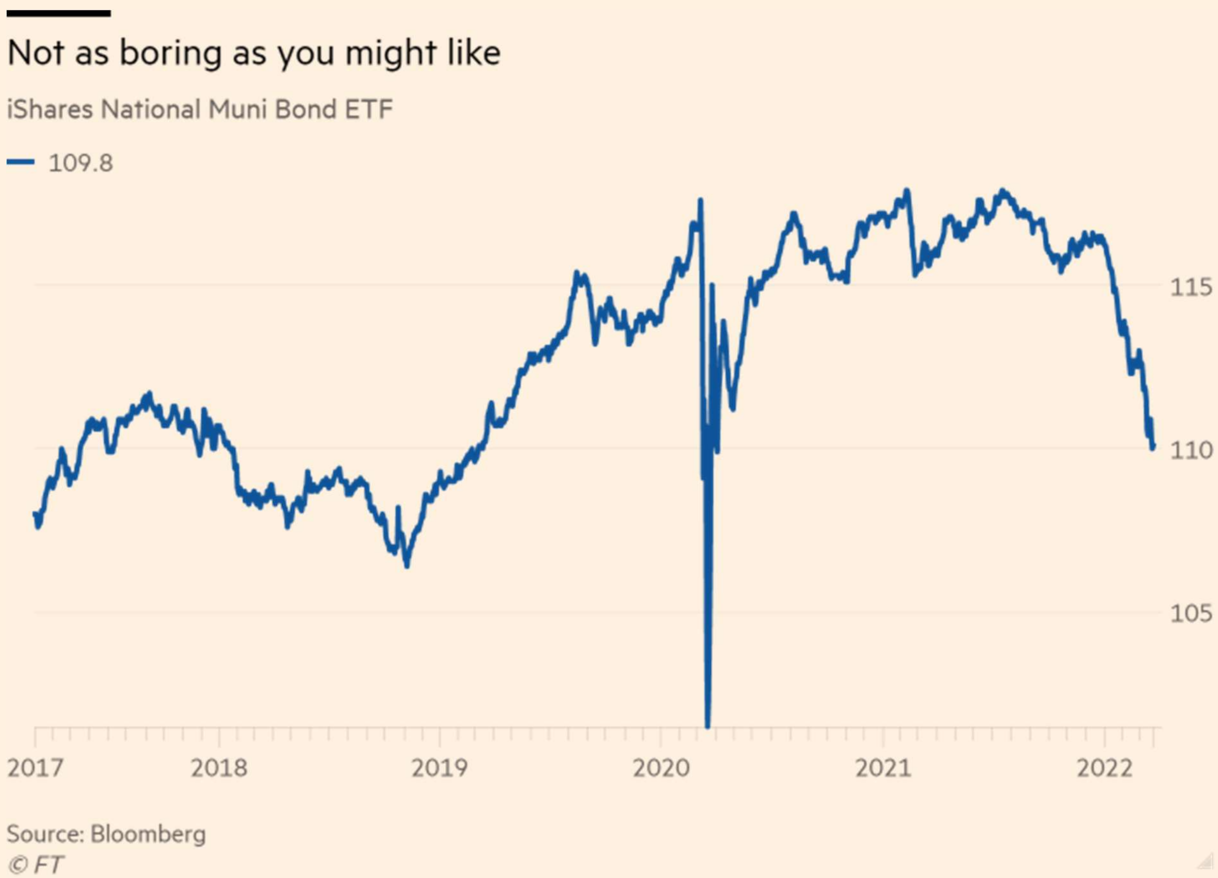
Muni bonds

There are probably not that many multitrillion asset classes that Unhedged has not written a single word about. Indeed, municipal bonds may be the only one. Munis are considered rather staid, and their core appeal is the tax-protected yield, so why bother.

Well, about that. Here is a Bloomberg story from Wednesday:

> The $4tn state and local-debt market just logged its most volatile 10-day period since the early 2020 sell-off, according to data compiled by Bloomberg. Benchmark yields rose as much as 11 basis points on Tuesday.
>
> The rout came after Federal Reserve chair Jay Powell's hawkish comments triggered a tumble in Treasuries as the central bank head seeks to tame the worst inflation in 40 years. Tuesday's move pushed the muni market to a 5.47 per cent loss this year, poised for its worst quarter since 1994.

That does not sound very staid. Here is a chart of the performance of one of the big, broad muni exchange traded funds:



As we have argued before, the return to normal after the Covid-era mass anaesthetisation of fixed income was always going to be messy. It should not be confused with some sort of harbinger of a crisis to come. That said, some particular features of the muni market make it worth watching at this transitional moment.

Steven Grey, who runs Grey Value Management, laid out some of these features for me. Muni bonds are not particularly liquid, meaning mild selling pressure can move prices quickly. A majority of the bonds have implicit call options embedded, a form of complexity poorly understood by many of the safety-oriented investors in them. Risky junk-rated munis are a small but growing slice of the market. So are bonds supported by private and semi-private enterprises, and sponsored by governmental "conduit issuers". Financial information about the municipalities and projects that back munis often becomes available only after a long lag and is hard to find.

Meredith Whitney loudly predicted in 2010 that muni bonds would be the kindling of the next financial crisis. "The Oracle of Wall Street" was wrong: muni bonds are more resilient than mortgage bonds, as it turns out. All the same, when fixed-income markets undergo rapid change, it is the supposedly sleepy forms of credit that bear watching.

I'm very keen to hear from readers who are active in the muni market who have thoughts on opportunities and risks.

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