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Outperformance at risk in $4tn US muni bond market

Debt sold by state and local governments has avoided worst of fixed-income sell-off

Municipal bonds fund projects like fund projects like school or bridge construction, attracting individual investors seeking their tax advantages © Michael Ciaglo/Bloomberg

Kate Duguid in New York OCTOBER 23 2022

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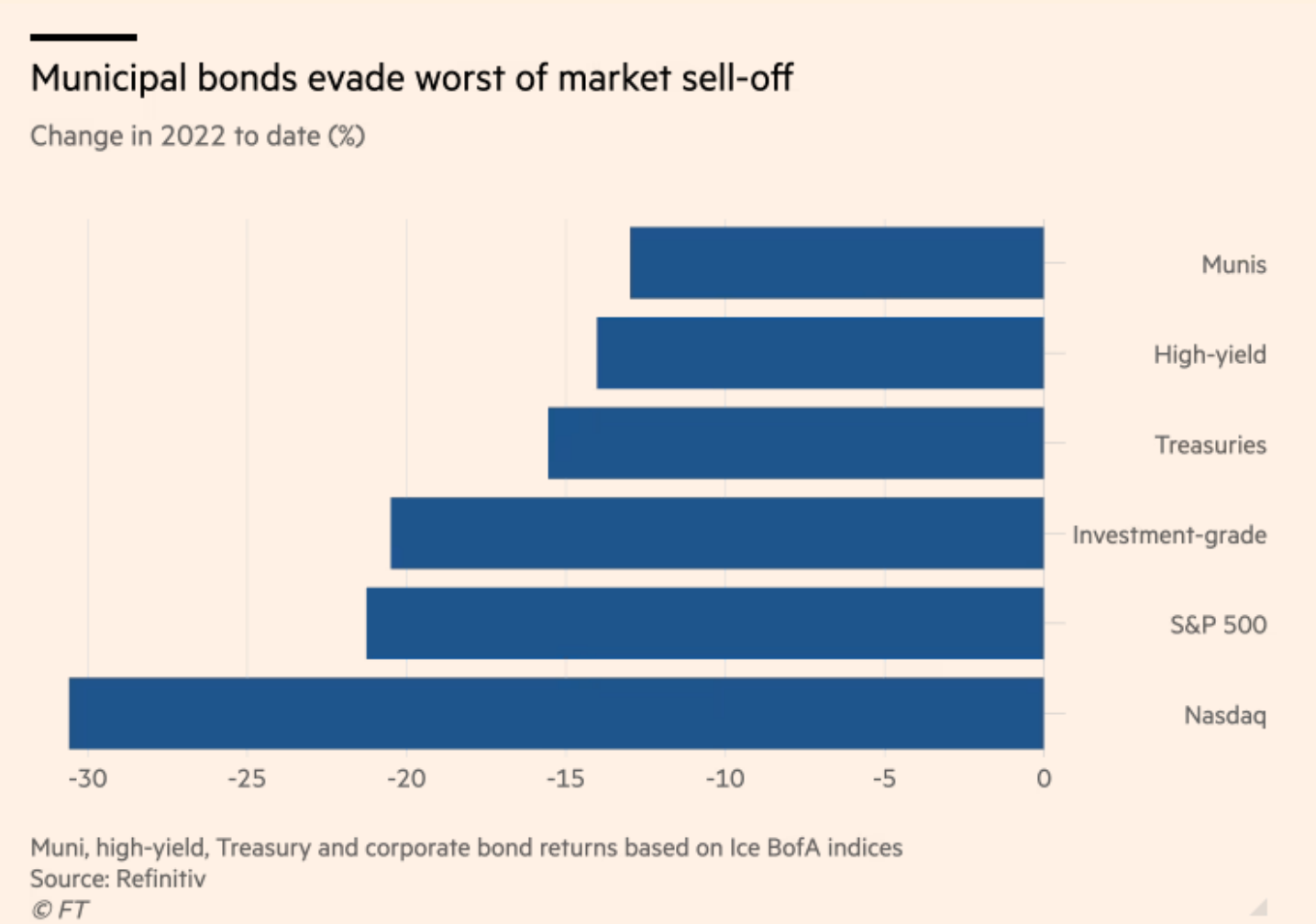
In a bleak year for fixed-income markets, US municipal bonds issued by state and local governments have stood out as being among the least-bad assets to own. The outperformance is now looking more tenuous.

The $4tn market for “munis”, often bought by individual investors attracted to their yields and tax advantages, has fallen by 13 per cent this year, according to the ICE BofA municipal bond index. The decline has been sharp for the muni market but less severe than benchmarks for Treasury bonds, investment-grade corporate debt or US equities.

Municipalities’ fiscal balances are still in good shape thanks to stimuli they received in the Covid-19 crisis, but the returns on their bonds reflect more than that. Investors and strategists warn that munis’ relative strength also reflects a dramatic slowdown in issuance and mispricing in the market.

The trend has been particularly clear since the end of September as munis have rallied while the supply of new bond issues has plummeted.



Issuance of the bonds governments use to fund projects such as school or bridge construction in the year to September has been the lowest since the first three quarters of 2019. Just $25.8bn of deals came to market in September, the slowest month since March 2020 at the outset of the pandemic.

Some now see a modest increase in new offerings, supply that threatens to put pressure on prices. Issuance rose to $10bn last week and Citigroup is expecting $10bn of issuance again this week.

"I had hoped to make a bullish call with conviction, but I can't," said Vikram Rai, head of municipal strategy at Citi. "When supply picks up in the coming weeks, the recent outperformance of munis is going to go away."

Borrowing costs are rising as the Federal Reserve pushes interest rates higher, which may force municipalities to act to avoid even higher rates.

Falling tax receipts may also drive new issuance. According to the most recent data from the Urban Institute, state tax revenue adjusted for inflation declined by 0.7 per cent during July and August from the same two months a year before.

Municipalities also often rush to issue bonds ahead of elections, fearing a change to policy.

"Issuance in our market was down dramatically in September. Usually October is a big month, but we'll see," said Peter Block, a managing director at Ramirez & Co, an investment bank that specialises in municipal debt. "Issuers that have flexibility are saying — we'll delay our deal that we had planned for October until things settle down. But if you have to issue, you have to issue."

Munis are traditionally buy-and-hold assets, owned by investors who collect the tax-exempt interest payments until maturity. Infrequent trading means that prices in the market often do not reflect current sentiment.

More issuance could boost trading volumes and liquidity, assigning new prices to bonds that haven't traded for weeks during a volatile period in Treasury and other fixed-income markets.

"Stale pricing is the defining characteristic of the muni market. It has always been a stale, dysfunctional market with lousy price discovery," said Steven Grey, chief investment officer of hedge fund Grey Value Management. "Everybody's sort of holding their nose and looking the other way."

The gap between the estimated valuation of munis and actual market prices is particularly wide at the moment because of this year's market volatility, said Nick Venditti, a muni fund portfolio manager at Allspring Global Investments.

"That is potentially dangerous for less sophisticated muni buyers, particularly if they are buying bonds at or near the [price evaluation determined by third-party providers], they are buying those bonds at what are almost certainly inflated levels," said Venditti.

If issuance fails to increase, the illiquidity of the market could continue to bolster prices.

"If you're talking about the performance of [a muni] index, if all the liquid bonds were to price overnight where they are supposed to trade, you will clearly have a big adjustment in the index.

But if the bonds don't trade, nothing happens," said Mikhail Foux, head of municipal research at Barclays, who does not expect muni prices to drop because of issuance or liquidity issues.

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