Municipal Bond Rates Remain Low Despite Fed Policy Action

The Federal Open Markets Committee (FOMC) met this week and Chairman Jerome Powell released a statement summarizing its meeting on Wednesday, December 15th. While the statement did not contain any elements of surprise, the direction in which the Federal Reserve (the Fed) is moving is substantial and noteworthy. First, Chairman Powell failed to include the term "transitory" in his remarks for the first time in recent memory when referring to the FOMC's inflationary expectations. This suggests that the supply chain issues driving the high rate of inflation may likely persist for longer than many originally thought.

Second, the FOMC maintained its position to keep short-term interest rates at or near zero (despite the recent rise in inflation) to help the labor market continue its trajectory toward full employment. However, many expect interest rate hikes are imminent in the new year and beyond. A survey of individual FOMC members indicates that 12 out of the 18 members believe there will be at least three rate hikes in 2022, with more to come in 2023 and 2024.

Third, the Fed will continue tapering (i.e., reducing) its bond purchasing program until the quantitative easing program comes to completion. The Fed had been purchasing $80 billion of US Treasury bonds and $40 billion of mortgage-backed securities for a total of $120 billion of asset purchases per month since March 2020. The tapering began in November, and in January, the Fed expects to purchase only $40 billion of US Treasury bonds and $20 billion of mortgage-backed securities on a monthly basis. This rapid tapering pace could have upward pressure on longer-term interest rates.

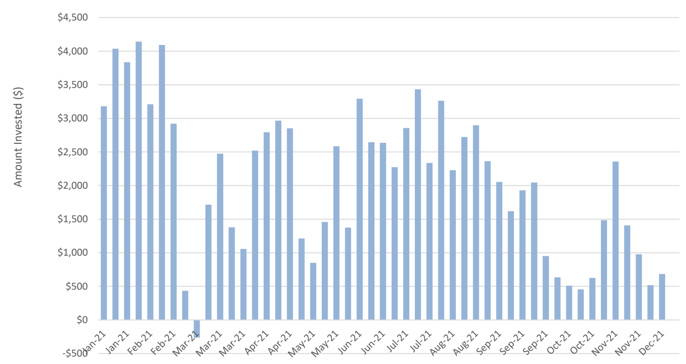
In the municipal bond market, we have yet to see the impact of these higher interest rate expectations. Municipal bond rates, as measured by the AAA Municipal Market Data Index (the MMD), continue to remain at attractive levels for issuers, and, in fact, have decreased since our last market update in mid-November. For instance, the 10-Year MMD closed on December 15th at 1.03%, which is 0.08%, or 8 basis points (bps), lower than where it closed on November 16th. The graph below shows how interest rates have moved since the beginning of 2020.

MMD Bond Index January 2020 - Current

The stability in the municipal bond market persists despite a relatively heavy supply in the primary market. The 30-day visible supply provided by The Bond Buyer showed over $15.7 billion of supply as of December 10th, which was an increase of over $2.1 billion from a week prior and the highest it has been in several months.

Fortunately for our issuer clients, demand is keeping pace with the healthy supply. The Investment Company Institute (ICI) monitors fund flows in to and out of long-term municipal bond mutual funds and exchange-traded funds (ETFs). Weekly fund flows have been positive for 48 out of the 49 recorded weeks this year thus far, exceeding $2 billion in 28 of those weeks. While net fund flows have remained under $1 billion for the last three weeks, the consistent positive flow into municipal bond funds have generated sufficient demand to keep tax-exempt interest rates at attractively low levels. Please see the bar graph below to see how robust municipal bond fund flows have been since January 2021.

Municipal Bond Fund Flows



It is not unreasonable to assume that the various fed policy actions and larger macroeconomic factors will force tax-exempt interest rates higher than where they are now. But that time has not yet come, prolonging the window of opportunity for issuers to take advantage of a historically low interest rate environment. If you have any questions about the municipal bond market in general or your specific bond issue, please feel free to contact a PMA advisor below. We here at PMA wish you all a wonderful holiday season.

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