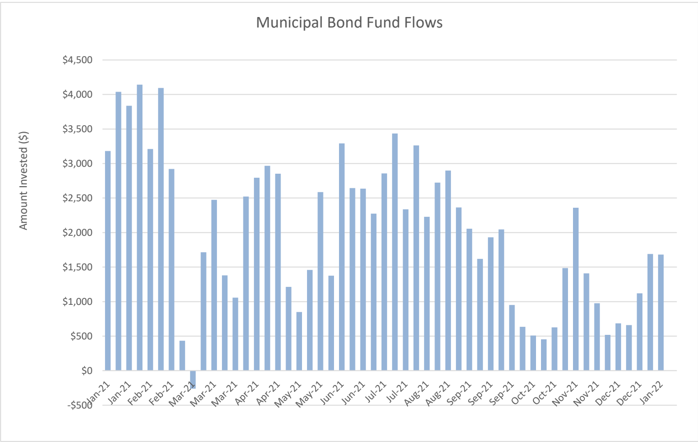
The Fed Responds to Inflation

Inflation continues to be the hot topic of 2022 as we start the new year. The final CPI data for 2021 was released earlier this week and showed a year-over-year CPI rate of 7%. This is the highest annual CPI rate since 1981 when it hit 8.9%. In December, the Federal Reserve (the Fed) concluded that inflation measures were higher than originally thought. In response, the Fed is now tasked with using its available toolkit to slow down inflation. The challenge for the Fed is to do so without causing a recession and a measured approach will likely be necessary. The three main actions the Fed has outlined to reduce inflation are: 1) raise the Fed Funds Target rate; 2) taper its asset purchasing program; and 3) reduce its balance sheet of the nearly $9 trillion in assets it currently holds.

The concern from the perspective of municipal borrowers is that both inflation and the measures that the Fed will take to reduce inflation will cause borrowing rates to increase. That concern has been realized in the early start to 2022. Since December 27th of last year, tax-exempt interest rates as measured by the Municipal Market Data (MMD) index, have increased by as much as 0.22%, or 22 basis points (bps). That change reflects the 5-Year MMD and increases have been seen throughout the yield curve but at a lower amount further out on the curve. Please see the graph below to see how interest rates have changed since January 2020.

MMD Bond Index January 2020 - Current

While fears of persistent inflation are causing upward pressure on interest rates, there is at least one factor that continues to apply downward pressure: demand. Demand for municipal bonds, as measured by municipal bond fund flows, continues to remain strong as it had throughout 2021. Last year's data from the Investment Company Institute (the ICI) showed positive flows into municipal bond funds for 51 out of the 52 weeks and net fund flows reached as high as $4.1 billion in a single week. Only one week of data is available for 2022, but the year is off to a good start as municipal bond fund flows were positive to the tune of $1.7 billion in the first week of the year, according to the ICI. Please see the bar graph below to see municipal bond fund flows since January 2021.



PMA looks forward to seeing what 2022 will hold for municipal issuers. If you have any questions about your specific bond issue or the bond market in general, please do not hesitate to reach out to an advisor below.


Michele Wiberg
SVP, Chief Sales & Marketing Officer
PMA Securities


Erik Kass
Director, Public Finance
PMA Securities


Brian Della
Director, Public Finance
PMA Securities

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