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Municipal Market Update
April 19, 2022

More Inflation Leads to Higher Yields

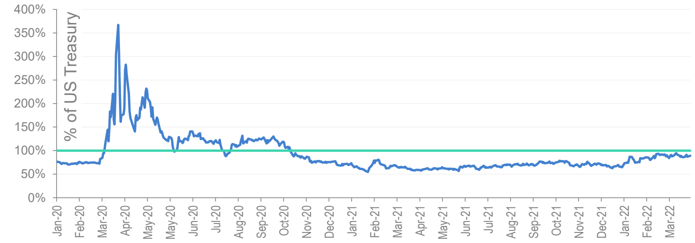
March inflation data was released last week, and the results continued inflation's recent trend as CPI reached a new 40-year high of 8.5%. Interestingly, however, once the latest CPI data was released, the 10-Year US Treasury fell by 0.08%, or 8 basis points (bps), from the prior day, moving in the opposite direction than most would have expected. The downward movement in the 10-Year UST was a result of core inflation coming in lower than expected. While that is an encouraging sign, the Federal Reserve (the Fed) appears to be undeterred from its inflation-fighting mission and will not be distracted by any glimmers of hope. In fact, many expect the Fed to increase short-term rates by 25-50 bps at its next meeting in early May instead of its standard step-up of 0-25 bps.

As the Fed fights inflation, rising interest rates continue to define the municipal bond market. Since the beginning of 2022, interest rates, as defined by the Municipal Market Data (MMD) index, are up as much as 1.62% depending on the term. In the last 10 days alone, the rise in rates has been as much as 20 bps as of April 18th. In fact, the MMD is nearing the spike reached in March 2020 when the municipal bond market all but closed in response to the onset of the pandemic. The graph below shows how the MMD has moved since January 2020.

MMD Bond Index January 2020 - Current

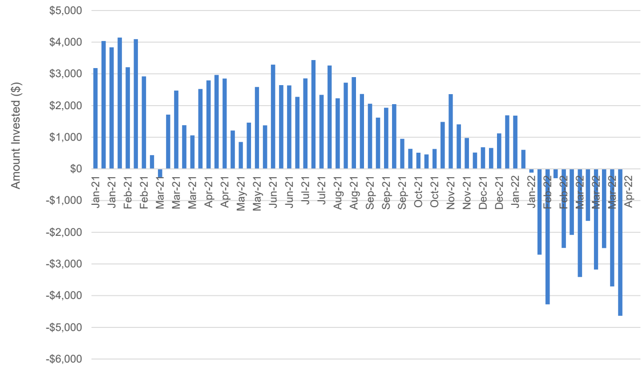
Furthermore, the rise in tax-exempt municipal bond rates is outpacing the rise in US Treasury rates. That comparison is captured well by the ratio between the 10-Year MMD rate and the 10-Year US Treasury rate. In 69.3% of trading days in 2021, this ratio remained below 70% and reached a low of 54%. That comes as no surprise given how low municipal bond rates were throughout 2021. However, this ratio is currently at 89% as of April 18th, and has reached as high as 95% on March 30th. This suggests that tax-exempt interest rates are high relative to its US Treasury alternative providing incremental value for investors who may be looking for a buying opportunity. Please see below for a graph showing this ratio since January 2020.

10-Year MMD vs. 10-Year US Treasury



Despite this apparent buying opportunity, the demand for municipal bonds has been weakening throughout the year as investors continue to pull their money out of municipal bond funds. The Investment Company Institute (ICI) monitors fund flows for municipal bond long-term mutual funds and municipal bond exchange traded funds. Since the beginning of the year, the ICI has recorded over $31 billion of outflows from municipal bond funds, averaging approximately $2.5 billion per week. The most recent week of data, as of April 6th, showed the highest outflow of over $4.6 billion in a single week. The graph below shows municipal bond fund flows since January 2021.

Municipal Bond Fund Flows



As we look forward to the rest of 2022 and beyond, it is important to understand the inflationary dynamics we are currently experiencing. Inflation has been so tempered for so long that experts are not only surprised by the current inflationary phenomenon, but they are also acknowledging that certain traditional views of inflation may no longer be relevant. A current understanding of inflation needs to consider recent economic phenomena like unprecedented federal stimulus, pandemic-induced supply chain issues, a shift in consumption demand from services to goods, and an ever more globalized economy where inflation is seen throughout the world and not just in the US. As economists, and in particular the Fed, establish economic theory to explain a new type of inflation, strategic measures to mitigate inflation without compromising economic activity can be implemented. Until then, inflation, and subsequently, higher interest rates, may be a reality we have to accept for longer than we would like.

If you have any questions about the municipal bond market or your specific bond issue, please do not hesitate to reach out to an advisor below.

Kent Johnson
Sr. Vice President, Director–Minnesota Office
PMA Securities

Steve Pumper
Vice President, Minnesota Office
PMA Securities

Michael Hart
Director, Public Finance
PMA Securities