Best-Rated Munis Deliver Worst Losses as Reflation Trade Roars
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By Anastasia Bergeron and Peyton Forte
(Bloomberg) -- Speculation that surging economic growth will drive up inflation is hitting the highest-rated municipal bonds the hardest.

State and local government debt with AAA credit ratings has lost 0.9% so far this year, almost triple the loss for the overall market, according to Bloomberg Barclays indexes. By contrast, municipal junk bonds and those on the cusp of losing an investment grade have eked out positive returns, making them refuges from the losses piling up elsewhere.

The returns reflect a shift across fixed-income markets this year as investors anticipate that economic growth will soar once the world emerges from the pandemic. That has pummeled the safest bonds, whose already rock-bottom yields gave them little buffer against rising interest rates. “Investors are looking for slightly lower-quality bonds with more spreads to kind of protect the portfolio in a rising interest rate environment,” said Bryan Didonato, a portfolio manager at Abner Herrman & Brock.

The concerns about credit risk that swept through the municipal market when the pandemic struck a year ago have largely faded, with President Joe Biden’s rescue plan extending more than $500 billion to states, cities, public transit systems and others that have sold bonds. The scale of the aid is in some cases more than enough to make up for the financial impact of the pandemic, leading Moody’s Investors Service to upgrade the outlook debt issued by colleges, airports and states.

That’s left investors largely trying to gauge whether the unprecedented amount of stimulus will drive up inflation and force the Federal Reserve to begin tightening monetary policy. In early March, a Bloomberg survey of economic forecasters found that they were expecting U.S. growth of 5.5% this year, the strongest since 1984.

As a result, benchmark bonds, whose yields hit unprecedented lows last year as investors rushed into the safest securities, have since fallen out of favor. The yield on 10-year top-rated muni bonds has jumped to over 1% from as little as 0.54% in August, according to Bloomberg’s BVAL indexes. “If you go to any investor and ask if they’d rather take more interest-rate risk or credit risk, I think nine times out of ten that investor might choose to take on more credit risk,” said Jonathan Law, a portfolio manager at Advisors Asset Management Inc.

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