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Bullish Individuals Driving 3-to-10-Year Bond Rally: Muni Credit

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By Andrea Riquier

Dec. 1 (Bloomberg) -- Mutual funds with municipal bonds due in three to 10 years are attracting money at the fastest pace in 14 months, signaling the segment may extend its biggest rally since 2009.

Investors added an average of $148 million a week to so- called intermediate funds since Oct. 5, the most since September 2010, Lipper US Fund Flows data show. The category is the "sweet spot" of the tax-exempt market, said **Neil Klein**, a senior managing director at Carret Asset Management in New York.

"That's where you're getting a significant proportion of the yield when compared to the long-term bond, but a significantly reduced portion of the interest-rate risk," Klein, who helps oversee $925 million, said in a telephone interview.

Buying by individuals, who own 21 percent of the $2.9 trillion muni market through funds, has helped drive yields on top-rated 10-year municipal debt down to 2.19 percent, or 1.72 percentage points below the 30-year rate, according to data compiled by Bloomberg.

The difference is the highest since June and is up from 1.12 percentage points on Oct. 14. It's the biggest jump since January 2009.

Seven- and 10-year local-government debt beat other maturities last month, gaining 1.24 percent and 1.17 percent, respectively, according to Barclays Capital data tracking prices and interest payments. Bonds due in more than 22 years earned 0.13 percent.

For the year, the long maturity is still ahead, earning 12.2 percent, to 9.55 percent for 10-years. The total return this year on the Standard & Poor's 500 index is 1.1 percent, while the S&P GSCI Spot Index of commodities has earned 4.1 percent.

With tax-free rates close to the lowest since the 1960s, some investors are reluctant to bet on longer-term debt. Should economic growth accelerate and fuel speculation that inflation will quicken, those maturities may suffer the most.

Intermediate municipal fund assets rose by about $1 billion since early October, while longer-term funds lost $27 million, Lipper data show.

Thirty-year Treasury yields at 3.06 percent yesterday were about 99 basis points above 10-year interest rates, the most in more than a week. A basis point is 0.01 percentage point.

The gap increased after the Federal Reserve and five other central banks cut the cost of emergency dollar funding for European banks in response to the continent’s sovereign-debt crisis. U.S. debt extended losses after a private report showed the U.S. added more jobs than forecast in November before the Labor Department releases employment data tomorrow.

“Rates someday are going to be higher than they are today,” said Scott Eldridge, who helps manage $800 million in municipals at Richmond, Virginia-based Caprin Asset Management LLC. “Most of that pain would be felt in the long end of the curve when they go up.”

At the same time, the Federal Open Market Committee’s policy of keeping its benchmark rate near zero dims the appeal of shorter maturities. Top-rated tax-exempt securities due in two years yield about 0.37 percent, according to Bloomberg Valuation data.

“Paltry rates earned for high-quality offerings in 1-5 years” are part of the reason that maturities from 2019 to 2024 are the “optimal portion of the curve” for some tax-exempt buyers, Peter DeGroot, head of municipal research at JPMorgan Securities LLC in New York, wrote in a Nov. 23 report.

Municipal issuers led by Puerto Rico are offering $7.5 billion of debt this week, as issuance rebounds from last week’s $1.9 billion of sales, the slowest since the five days ending Sept. 2. Sales for the month were set to total about $30 billion, the second-most of 2011 after October’s $31.8 billion, according to Bloomberg data.

State and local securities returned 0.54 percent last month, rebounding from a 0.41 percent decline in October, according to Bank of America Merrill Lynch index data tracking price changes and interest payments.

Municipal returns trailed the 0.73 percent gain in Treasuries for November, the data show. For the year, their 9 percent earnings are beating Treasuries’ 8.8 percent.

Following are descriptions of planned sales:

NEW YORK, which may face a budget gap as large as $3.5 billion next year, plans to sell $317 million of general- obligation bonds by competitive bid as soon as next week, according to a preliminary official statement. The bonds will be used to finance transportation and environmental projects. A $31 million portion of the deal is taxable. Fitch Ratings grades the deal AA, its third-highest. (Added Dec. 1)

PHILADELPHIA plans to sell $237 million of revenue refunding bonds for its airport as soon as next week, according to a preliminary official statement. Two portions of the sale, totaling $204 million, are subject to the alternative minimum tax and the remainder is federally taxable. Fitch grades the bonds A, its sixth-highest. RBC Capital Markets will lead the deal. (Added Dec. 1)

HEMPSTEAD TOWN LOCAL DEVELOPMENT CORP. plans to sell $73 million of revenue bonds on behalf of Long Island’s Hofstra University, which enrolls about 12,000 students, as soon as next week, according to a preliminary official statement. S&P rates the bonds A, its sixth-highest grade. Barclays Capital will lead the deal. (Added Dec. 1)

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