

CHAPTER 17

Factors Determining Municipal Bond Yields*

THE NEW ISSUE YIELDS OF MUNICIPAL BONDS are the result largely of the interaction of four groups of measurable market forces, as follows:

1. The prevailing yields at that time of similar taxable bonds.
2. The effective income tax rates then applicable to each of the various investor groups which regularly make fixed interest investments. These rates determine the value of tax exemption to each investor group.
3. The volume of new investible funds flowing to each of these investor groups. This determines the potential significance to the municipal market of the tax rates applicable to each investor group.
4. The volume of new bond financing desired by all states and municipalities at around prevailing yields.

To the above list of four specific measurable market forces must be added two more groups of forces which are far less specific and measurable.

5. Expectations. For example, the market might expect higher or lower tax rates generally or for specific types of investors. Alternatively, specific individuals or institutions might expect that their own brackets will rise or fall due to a change in their earnings. Again a change in the volume of tax-exempt financing might be expected or a change in the flow of new investible funds.
6. Institutional restrictions. Laws, customs, and liquidity needs limit the free interflow of investible funds from one department of the investment market to another solely for yield advantage. The best net after tax yield is an important guide to the allocation of loanable funds, but is far from the sole guide.

The market forces will first be discussed separately to see how they affected recent yields, and then in combination over a long period of years. First of all it will be useful to illustrate the effect of each at one recent point of time.

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