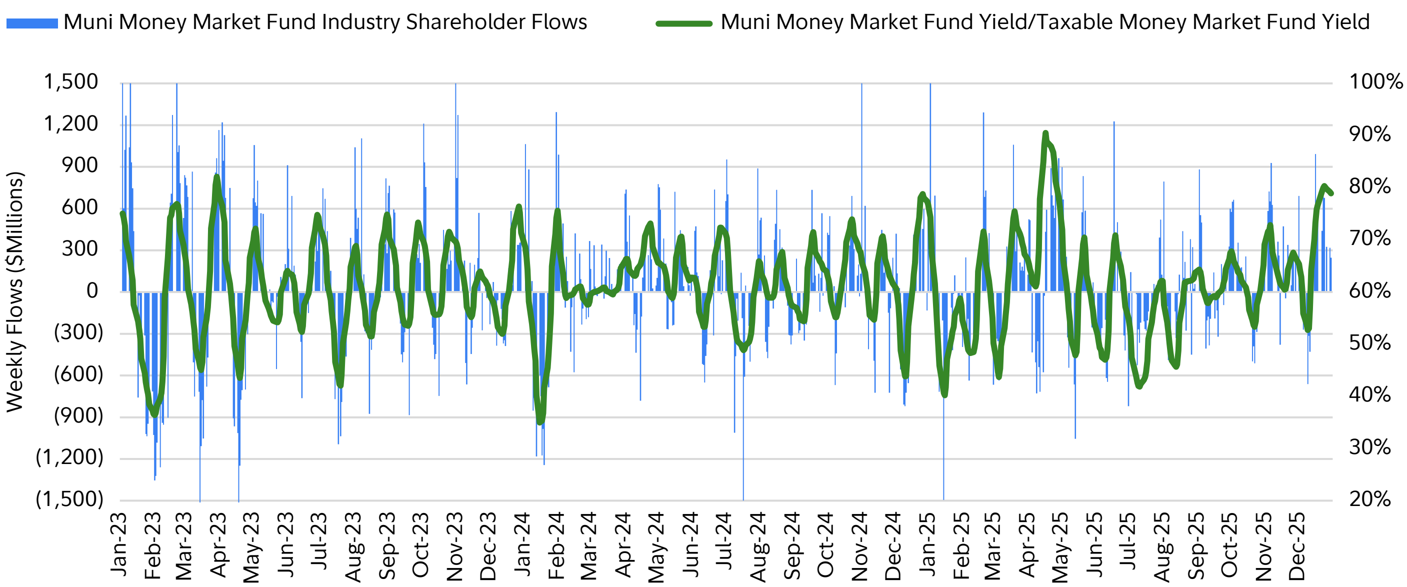
Understanding municipal money market dynamics: Municipal Money Market Fund yield volatility

One advantage of investing in municipal money market funds–in addition to potential tax benefits–is that they provide a market-based yield as a key feature that sets them apart from similar instruments. The Federal Reserve (Fed) meets its policy goals by adjusting short-term interest rates, primarily through setting the Fed Funds rate. Municipal money market fund yields generally follow the direction of the Fed Funds rate, but they also exhibit other notable fluctuations due to the unique supply-demand dynamics of the securities that municipal money market funds hold.

Fidelity's municipal money market funds typically hold between 60% and 80% of their assets in securities with interest rates that adjust on a daily or weekly basis. Due to significant exposure to these variable rate securities (VRS), the yields on our municipal money market funds generally move in the same direction as short-term municipal interest rates. The rate on VRS is set by the bank that is hired by the municipal borrower to serve in the role of remarketing agent. To ensure the rate reflects a market-based level, holders of VRS, such as municipal money market funds, have the right to sell the securities back to the bank for same-day or one-week forward settlement. This right to sell is commonly referred to as a "put option."

Ever since the Federal Reserve started raising interest rates in March 2022, many investors have been moving back and forth between taxable and municipal money market funds, attempting to achieve an optimal after-tax yield. When the ratio of municipal money market fund yields to taxable money market fund yields falls below 60%, municipal money market funds have tended to experience outflows as investors rotate into taxable money market funds. When that ratio is above 60%, investors have favored municipal money market funds.

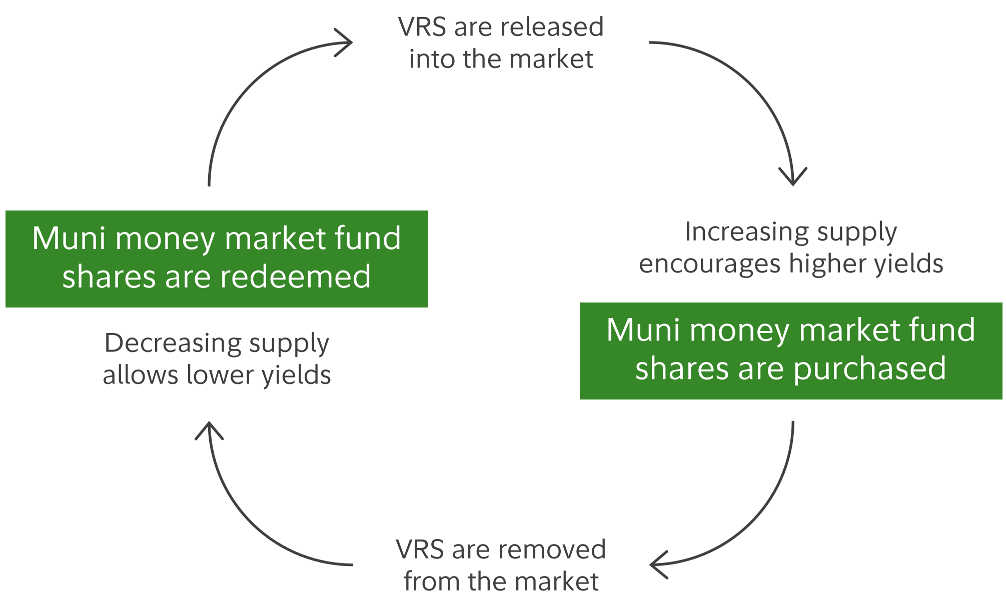
Exhibit 1: Ratio of muni money market fund yields to taxable yields vs change in assets



Source: FMR, Bloomberg as of 12/31/2025

When municipal money market funds experience outflows, they typically exercise their put option on VRS to meet shareholder redemptions, thereby increasing the amount of these securities the banks must stock in their inventory. The banks then raise the rates on VRS to attract new buyers and prevent an undue accumulation of securities held in their inventory. Since a substantial portion of municipal money market funds remain invested in VRS, the higher VRS rates increase the yields on municipal money market funds, attracting investors back to those funds. The influx of cash to municipal money market funds increases demand for VRS, which allows the banks to lower their rates and the cycle repeats.

Exhibit 2: Muni money market fund supply-demand cycle



Source: FMR

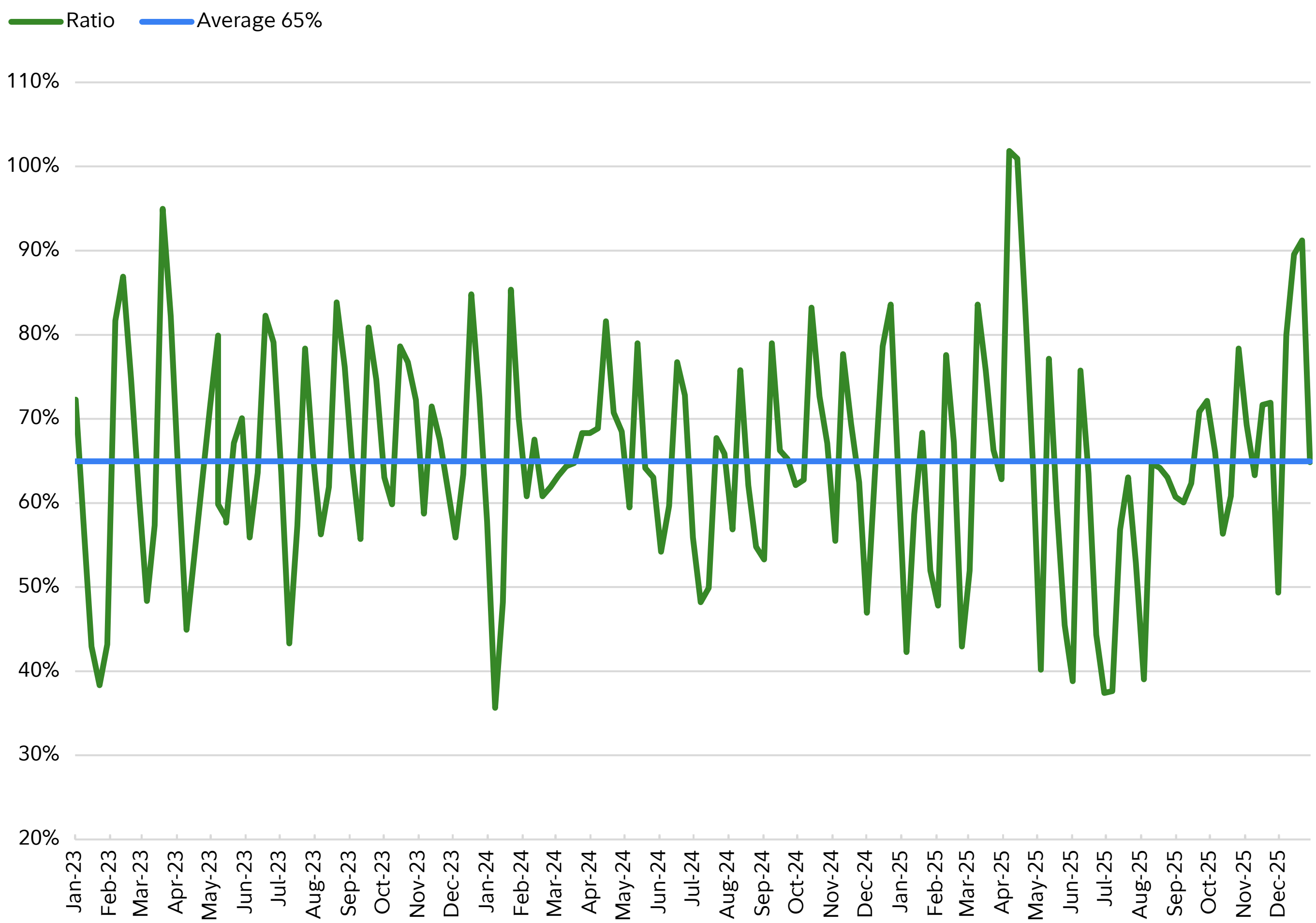
The Securities Industry and Financial Markets Association (SIFMA) municipal swap index is the benchmark for short-term municipal interest rates. It is comprised of VRS with a weekly rate reset and the index is calculated each Wednesday as the average rate of all securities that qualify for inclusion. The waves of shareholder inflows and outflows experienced by municipal money market funds have led to volatility in the SIFMA index.

In addition to the volatility caused by investor flows, the SIFMA index is also affected by certain recurring seasonal factors. For example, most municipal bonds have principal and interest payments due at the beginning of each month, with especially large payments due on January 1 and July 1. When these bonds are paid, cash is returned to holders, which increases demand for new municipal securities, including VRS, and pushes yields and the SIFMA index lower. By contrast, banks tend to increase rates on VRS at year-end to reduce the amount of securities for which they need to account in managing certain regulatory capital requirements and surcharges. Therefore, the SIFMA index is prone to spike at year-end.

The volatility in municipal money market fund flows, as well as the seasonality factors noted above, are likely to continue, triggering large fluctuations in the rates on VRS and municipal money market fund yields. Despite the ongoing yield volatility, municipal money market funds have demonstrated value over longer time horizons.

Exhibit 3: Weekly SIFMA index vs. effective federal fund rate yield ratio

2023–2025 average ratio was 65%



Source: FMR, SIFMA, Federal Reserve as of 12/31/2025

Effective Federal Funds Rate (EFFR) is the weighted average overnight interest rate that banks earn when lending surplus balances held at Federal Reserve Banks to each other.

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