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WSJ: Falling Rates, Rising Tax Risk Give Some Shine to Muni Bonds.

State and municipal governments and agencies have increased issuance of debt by 39% this year

Municipal bond issuance in the U.S. is heating up as local governments ramp up borrowing and investors gobble up the low-risk securities.

Industry experts said local governments have needed to borrow more as the massive federal stimulus received during the pandemic wears off. Issuances also are increasing in size, as the cost of projects become more expensive due to rising prices for materials, labor and services. Meanwhile, as the Federal Reserve cuts interest rates, yield-seeking investors have more reason to park their cash in munis.

"We were looking for a decent pick up year over year, the magnitude of the increase is what is a bit surprising," said Sean Carney, chief investment officer of municipal bond funds at BlackRock, which manages about $188.4 billion in the asset class. municipal bonds. "I think we're heading back to kind of the pre-Covid time frame where…we're going to see a period of elevated supply."

State and municipal governments and agencies have issued $447 billion of debt in the first ten months of this year to finance everything from affordable homes to airports to water and power supplies, according to Refinitiv data via the Securities Industry and Financial Markets Association. That is a 39% increase from a year earlier, even as borrowing costs in the period held at a multi-decades high. Sifma data also shows a higher volume of municipal bond trading this year.

Demand has outpaced supply in recent auctions by substantial margins, Carney said. The performance is attracting wider attention to a part of fixed-income markets mostly tapped by deep-pocket investors. "Sometimes we feel like the lost asset class," Carney said.

He estimates this year's issuance will total $475 billion, or around $105 billion above the total of bonds retired or refunded.

Having to pay higher interest rates hasn't been much of a deterrent for local governments. "You can't ask your failing roadway or water system to hang in there until rates fall," Carney said.

Issuers may also have been trying to get ahead of the election, said Chad Farrington, co-head of U.S. municipal bonds at DWS. In fact, some analysts expect issuance to ease after Tuesday's vote, before rebounding next year once markets have a clearer view of government policies.

On the demand side, flows into municipal-bond funds increased to $26.5 billion this year through August, from $8 billion in the same period last year, according to the Investment Company Institute via FactSet.

Fund managers say that munis, like other fixed-income instruments, are increasingly becoming the new destination of funds parked for years in cash-like options such as certificates of deposit, which have lost appeal as the Fed cuts rates.

Then there is the tax factor. Municipal bonds’ returns are often exempt from income tax. That feature is getting more relevant as certain provisions enacted in 2017 that benefited wealthy taxpayers are set to expire late next year.

“My clients are looking toward the Tax Cut Job Act expiration in 2025,” said Kathleen Grace, chief executive officer of the Fiduciary Family Office. The boutique investment firm has $600 million of assets under management for clients who have an average net worth of $20 million. She said it makes sense for them to increase their holdings of assets offering tax-free returns to minimize the potential increase in federal taxation.

“We think those two factors are causing investors to get into the muni market, you know, [returns in] cash equivalents being lower and the prospects for higher taxes,” said Dan Close, who heads Nuveen’s $190 billion municipals division.

“If you’re of the opinion that there is higher taxes in the future, one of the best ways to position your client’s portfolio is to buy these state and local government bonds that finance infrastructure locally” and are exempt from federal and often state and local taxes as well, Close said.

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