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Nervous About Borrowing, U.S. States and Cities Alter Municipal Bond Landscape.

(Reuters) – U.S. cities and states are leery of borrowing more money despite near-record low interest rates, forcing bond funds to scour for investments and boosting returns on existing debt.

The drought in issuance is also slowing city and state capital projects and threatens to disrupt the summer high season for bond buying.

So far this year, sales are running 25.4 percent below the same period in 2013, according to preliminary Thomson Reuters data. May's issuance, $22.41 billion of bonds sold in 907 deals, was the lowest for the month in three years and the smallest since January, when only $18.17 billion in bonds came to market.

The paltry pace of issuance has investors competing to get a slice of new deals and in many cases forcing them to bid on lower-quality credits than they would like.

"Many of the new issues that are coming to market are eight to 10 times oversubscribed. So it's difficult getting bonds," said Burton Mulford, portfolio manager at Eagle Asset Management, which emphasizes high-grade debt.

Eagle has begun buying more single-A credits, the mid-to-low end of the investment-grade scale. Instead of focusing on deals of at least $75 million, it has been looking at some $35 million and $40 million deals, Mulford said.

Cities and states' refinancing binge, which was fueled by low interest rates, ended in 2013 as rates rose and retail buyers avoided the municipal market, spooked by bad financial news from Detroit and Puerto Rico. Issuance started falling.

As 2014 dawned, many expected bond sales to drop further, given that governments' financial managers are gun-shy about taking out debt after the budget crises resulting from the 2007-09 recession. Political leaders facing elections in November, too, may want to appear conservative about borrowing.

Last year's 0.4 percent growth in municipal bond sales was the smallest in 20 years, and the trend is set to continue "because of the slow and uneven pace of revenue recovery," according to Moody's Investors Service.

Most states are not fully utilizing their borrowing capacity and are spending less on infrastructure, which is primarily financed by bonds, the National Association of State Budget Officers said in a report released on Thursday. The growth in debt for infrastructure in almost all states has been "very minor or flat" despite the era of low interest rates, the group found.

Spending austerity and political attitudes, along with lack of federal policy supporting infrastructure spending and higher interest rates, will keep the year's total bond sales between $250 billion and

$275 billion, Janney Capital Markets estimated. Last year's sales totaled $311.8 billion.

"It's helping drive prices up and yields down, but demand is pretty strong as well," J.R. Rieger, head of fixed income at S&P Dow Jones Indices said of the supply shortage. "The muni market started the year relatively cheap compared to Treasuries and corporates… I think investors recognized it."

The S&P Municipal Bond Index has had a year-to-date return of 6.09 percent. The high-yield index has returned 9.65 percent, more than double its counterpart for U.S. corporate junk bonds.

Yields started 2014 fairly high but have recently fallen. Those on top-rated 10-year bonds began 2014 at 2.79 percent and on highly rated 30-year debt at 4.20 percent on Municipal Market Data's benchmark scale. By the end of last week, 10-year bonds were at 2.16 percent and 30-years at 3.26 percent.

Meanwhile, yields on A-rated, 10-year bonds were 2.77 percent and on A-rated, 30-year issues were 3.89 percent on Thursday, according to MMD, a Thomson Reuters company.

With $8.6 billion in deals expected to come to market this week, the supply shortage could ease during the summer. Still, investors might be caught scrambling to find places for the cash they receive from bond redemption and coupon payments during the summer "reinvestment season."

Loop Capital Markets expects the amount of cash coming available in June, July and August to total $151.53 billion, down slightly from $160.74 billion last year.

Loop has revised its forecast for 2014 issuance to $275 billion from the $300 billion it estimated in December. But Loop Managing Director Christopher Mier said the combination of large amounts of cash with short bond supply may not have a predictable impact on the market.

"You can't just assume this money is coming back, and there's a particular reason you don't want to make that assumption this year: there's been a significant decline in yields and a significant outperformance," he said. Mier added that investors may opt to buy equities instead.

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