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Muni Debt Prices Storm Back After Last Year's Rout

Municipal-bond prices have come roaring back, reversing last year's rout despite enduring financial challenges facing U.S. cities and states.

The resurgence in the \$3.7 trillion market comes as bond buyers attempt to find higher investment returns amid a tumble in U.S. interest rates.

Long coveted by mom-and-pop investors for their tax benefits and relative stability, municipal bonds - debt sold by cities, states and local government-related entities - are benefiting from a broad bond-market rally and a decline in new debt being issued by municipalities that are still trying to tighten their belts.

The municipal-bond market posted its worst year in 2013 in almost two decades, registering losses in the wake of Detroit's record municipal bankruptcy-protection filing, concerns over hefty pension costs in Illinois and economic worries in Puerto Rico.

Investors have poured \$3.1 billion into municipal-bond mutual funds this year, compared with \$2.96 billion over the same period in 2013, according to data from Lipper as of Wednesday. The gains mark a shift after investors pulled \$39.9 billion from the funds in the last 31 weeks of 2013, the data show.

Yields on municipal debt fell to 2.325% on Wednesday, according to Barclays PLC, their lowest in almost a year. Yields fall when prices rise.

The gains have made the debt a star performer for investors this year, in a twist few predicted. Municipal bonds have returned 5.869% in 2014, reflecting interest payments and price appreciation. That compares with total returns of 5.769% on highly rated corporate bonds, 3.3% for the S&P 500 and 2.982% on U.S. Treasury debt, according to Barclays data.

"I don't think the need for tax-exempt income ever went away, and there appears to be pent-up demand," said John Miller, co-head of fixed income at Nuveen Asset Management LLC, which oversees about \$90 billion in municipal bonds.

Cities and states aren't borrowing enough to meet the demand from investors, said Vikram Rai, a fixed-income strategist at Citigroup Inc., which forecasts issuance will fall to \$280 billion this year, from \$334 billion in 2013. "The primary market supply is very anemic and that's really driving down yields," he said.

Many municipal bonds are still considered nearly as safe as Treasuries, because they are backed by the taxing authority of various governments. Their prices typically move in tandem with the U.S. government-debt market, and this year, Treasury bond prices have staged a surprising rally.

The riskiest municipal bonds are rallying the most, though many brokers and investment advisers

still are steering retirees and other individual investors away from junk-rated municipal bonds, as their clients are looking for stable income and savings.

These buyers generally “are looking for the safety that muni bonds have and shy away from those municipalities that have lower credit ratings or are in trouble,” said Benjamin Chuckrow, a senior vice president with Wells Fargo Advisors in Saratoga Springs, N.Y.

He warns clients interested in municipal debt that there are two types of risks to consider: whether the issuer is in good financial health and what may happen to the bond’s value between now and when it matures. If interest rates rise before the bond matures, investors who want to sell beforehand could get lower prices.

To be sure, some state and local governments are struggling to mend their finances amid anemic U.S. economic growth. Many have cut their budgets and plugged pension gaps.

Puerto Rico is attempting to recover after its debt was downgraded to junk in February, but the bonds’ prices have risen since the U.S. territory sold \$3.5 billion of debt in March. One Puerto Rico general obligation bond traded at 71.5 cents to the dollar this week, up from 63.75 in December. The S&P Municipal Bond Puerto Rico Index has returned 10.6% this year through Wednesday.

In comparison, high-yield municipal bonds have returned 9.33% this year, Barclays said.

Illinois, which has struggled to address its underfunded pension, in February sold \$1 billion in general obligation bonds, paying less to borrow than the state did eight months earlier. The new deal came as lawmakers reached an agreement that would close the pension gap by about \$100 billion.

“State and local governments were in a severe squeeze following the housing downturn and the deep recession,” said Dean Maki, chief U.S. economist at Barclays. “Now, that is stabilizing.”

Rising federal tax rates also have brought investors back to tax-exempt municipal debt, said George Rusnak, managing director of global fixed income at Wells Fargo Private Bank. “You’re seeing individuals have stronger demand for tax-free income,” he said.

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