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Record Debt Shrinkage Means Growing Bill for U.S. Roads.

The U.S. municipal-bond market is performing a vanishing act.

While businesses and consumers are borrowing more as the economy revives and the Federal Reserve holds its benchmark interest rate near zero, America's local governments are doing the opposite. States, cities and public agencies have reduced their debt load by $111 billion since 2010, the biggest decline peak to trough since records began in 1945, according to Fed data released yesterday.

The $3.66 trillion market is on pace to contract for an unprecedented fourth straight year. Localities recovering from the recession that ended five years ago are paying down debt instead of pumping money into aging roads and bridges. The scarcity of bonds has helped fuel the longest rally in munis since 1991.

"There is a retrenchment going on, and I think that's going to continue," said Tom Kozlik, director of municipal credit analysis at Philadelphia-based brokerage Janney Montgomery Scott LLC. "One of the last things that an issuer wants to do, if it doesn't have to, is add fixed costs in terms of debt."

Municipalities have sold about $106 billion of long-term, fixed-rated bonds this year, a 25 percent decline from the corresponding period of 2013, data compiled by Bloomberg show.

Surprising BlackRock

"The low absolute level of gross issuance has caught the market, including ourselves, a little by surprise," said Sean Carney, a muni strategist at New York-based BlackRock Inc., which manages $108 billion of local debt.

Issuers from California, the most-populous state, have offered 47 percent fewer bonds this year. The nation's most-indebted state has focused on spending money raised in previous sales instead of borrowing more, said Tom Dresslar, spokesman for Treasurer Bill Lockyer.

Another reason for the borrowing dip: The state has fewer bonds to refinance after a wave of such deals last year. California has refunded $800 million of debt in 2014, down 72 percent from a year earlier, according to Dresslar. Meanwhile, sales of bonds for new projects have dropped 24 percent.

"We have taken a somewhat more conservative approach for the last couple of years or so," Dresslar said.

1991 Redux

Even as the menu of muni offerings has diminished, individuals have been chasing the rally in tax-free bonds. Investors added $2.9 billion to muni mutual funds in May, Chris Mauro, a strategist at RBC Capital Markets in New York, wrote in a June 4 research note.

Munis have gained each month this year, the first time that's occurred since 1991, according to Bank of America Merrill Lynch indexes. The market has earned 6.2 percent in 2014, compared with

5.1 percent for corporate bonds.

The performance is more a sign of dropping supply than surging interest in tax-exempt securities, said Chris Mier, chief muni strategist at Loop Capital Markets in Chicago. The market is dominated by individual investors, who own more than half of local-government debt.

“It’s not that the demand is inordinately high, it’s just that the supply impact is stronger,” said Mier.

2010 Peak

The market began to shrink after the end of the Build America Bonds program, an economic-stimulus measure that began in 2009 and subsidized interest costs of debt that localities sold for infrastructure projects. Issuance under the program tallied $188 billion by the time it lapsed at the end of 2010. Municipal issuance that year totaled $408 billion, the most since at least 2002, Bloomberg data show.

Borrowing has also waned as a result of a political shift among officials forced to cut budgets when tax revenue faltered during the recession that ended in June 2009.

“It is understandable given the pull-forward that had taken place in past years, coupled with post-crisis management styles and general aversion to adding new debt,” BlackRock’s Carney said.

California Governor Jerry Brown, a Democrat, has pledged to chip away at debt used to pay for prior shortfalls, and has moved to save surplus tax money. In Florida, Republican Governor Rick Scott has boasted of cutting $3.6 billion of debt.

Mier, the Loop analyst, said the aversion to borrowing will ebb as municipalities’ finances recover. It wasn’t until a year ago that state tax collections recovered to their 2008 peak, adjusted for inflation, according to the Nelson A. Rockefeller Institute of Government in Albany, New York.

Officials have a ready list of projects to tackle. Areas such as schools, roads, transit and water need about $3.6 trillion of investment by 2020, according to a report last year from the American Society of Civil Engineers.

“The political sentiment will move back in the other direction and you will see more debt issuance again,” Mier said.

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