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Supply Doldrums End in Citigroup $330 Billion Call: Muni Credit.

The supply slump that's fueling the best run for municipal debt since 2009 is poised to end next year as governments ramp up borrowing for long-delayed projects from water to transportation, Citigroup Inc. predicts.

States and localities are set to borrow $330 billion in 2015, 18 percent more than this year, for the first increase in annual issuance since 2012, according to Citigroup. Governments will need to meet regulations for water and sewer systems and finance road and bridge upgrades, said George Friedlander, chief municipal strategist in New York at the third-biggest U.S. bank by assets.

An increase would be a welcome change for investors who are struggling to find bonds in 2014. Localities have sold $123 billion this year through June 13, the slowest pace since 2011, following a 15 percent drop in issuance last year, data compiled by Bloomberg show. Banks that handle the sales also stand to benefit should a renewed borrowing wave generate more underwriting fees.

"There's a lot of pent-up need for infrastructure," said Friedlander, whose bank was the third-biggest muni underwriter in 2013. "That's been true a long time, but some of it is reaching its maturation age where it needs to get done, water in particular."

Investment Lacking

The municipal market shrank the past three years as the 18-month recession that ended in 2009 led officials to curb spending and capital projects. There is work to be done: Municipalities need about $3.6 trillion of infrastructure investment by 2020, according to a 2013 report from the American Society of Civil Engineers.

The issuance drop has helped propel the $3.7 trillion market to a 6.1 percent gain this year through June 18, surpassing earnings of 2.6 percent for Treasuries and 5.2 percent for investment-grade corporate debt, according to Bank of America Merrill Lynch data.

With fewer sales, the cash available to purchase new borrowings often surpasses deal sizes, said Peter Hayes, head of municipal debt at New York-based BlackRock Inc., which oversees $108 billion of local securities. Investors are also less likely to sell their bonds, he said.

"Deals are so oversubscribed, not only from the traditional muni buyers but from the non-traditional buyers as well," Hayes said.

Vying Viewpoint

Janney Montgomery Scott LLC, meanwhile, sees the bond drought worsening.

Issuance will decrease every year to as low as $175 billion in 2017 as rising interest rates and an austerity push limit borrowing, Tom Kozlik, director of municipal credit analysis in Philadelphia,

wrote in a report last month.

As the economy strengthens, yields on 10-year Treasuries, a benchmark for borrowing rates, will climb 0.72 percentage point to 3.35 percent a year from now, according to the median forecast of 73 analysts in a Bloomberg survey.

The years of $300 billion or more of total issuance “are likely in the past,” Kozlik said.

Janney’s 2017 call would mark a decline of about 60 percent from the peak level of 2010, the final year of the federally subsidized Build America Bonds program.

Function First

BlackRock doesn’t expect issuance to sink as low as Janney predicts and estimates annual volumes will range from $275 billion to $325 billion, said Sean Carney, a muni strategist at BlackRock.

“That seems like the home for municipal issuance going forward,” Carney said. “There’s just a certain amount of issuance that needs to come each year to function.”

Municipalities may borrow more as increasing revenue swells spending limits, Carney said.

U.S. states plan to raise expenditures in fiscal 2015 for the sixth straight year, although the projected 2.9 percent boost would be the slowest rate since 2010, according to a report from the National Association of State Budget Officers.

A pickup in state and local borrowing would also mean more business for underwriters.

The governments paid banks $523 million to handle $97.4 billion of long-term deals this year through May, based on an average cost of issuance of $5.37 per $1,000 of bonds, data compiled by Bloomberg show. That compares with $691 million on $127 billion of debt in the same period last year, based on an average cost of $5.46 per $1,000.

Needs Abound

In Citigroup’s estimation, issuers will direct the additional bond proceeds to water and sewer systems, roads and hospitals.

Health-care systems may move forward with projects after assessing the fallout of the 2010 Patient Protection and Affordable Care Act, Friedlander said. Localities that have been waiting for Congress to replenish the U.S. Highway Trust Fund, which pays for transportation projects with gasoline and diesel-fuel taxes, will instead finance road and bridge upgrades on their own, he said. Lawmakers are working on an infusion into the fund, which is set to run out of cash in July, according to the U.S. Department of Transportation.

“The amount that’s being funded now is a small portion of what needs to be in the highway, bridge and tunnel area, but it will get gradually higher,” Friedlander said.

Utilities will need to update water systems and address environmental regulations, Friedlander said. Drought may also spur issuance, according to Philip Fischer, head of muni research in New York at Bank of America.

Drought covered about 37 percent of the contiguous 48 states, particularly California, Texas and Oklahoma, as of June 3, according to a report from the National Drought Mitigation Center at the

University of Nebraska, Lincoln.

“There seems little double that the threats posed by droughts of this magnitude demand a large uptick in new water infrastructure investment,” Fischer wrote in report this month.

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