[Bond Case Briefs]

Municipal Finance Law Since 1971

[Record Rally Revived With Least Issuance Since 2001: Muni Credit.]

July 31 (Bloomberg) — The rally in the $3.7 trillion municipal market is picking up momentum, extending an unprecedented streak of gains as issuance sputters to the slowest pace in 13 years.

Bonds of U.S. states and cities have earned 0.3 percent this month, after climbing in each of the first six months of 2014, a record run to start a year, according to Bank of America Merrill Lynch data beginning in 1989. In June, the debt returned 0.003 percent.

The issuance slowdown and steeper tax bills are outweighing concern that struggling Puerto Rico, whose bonds are held by 66 percent of U.S. muni mutual funds, may restructure some obligations. Inflows to muni mutual funds totaled $844 million the past two weeks, Lipper US Fund Flows data show. That marks a recovery after the U.S. territory's June move to allow public corporations to cut their debt through negotiation spurred investors to yank $790 million in a week, the most since January.

The Puerto Rico law "hit our market, but it was pretty isolated in terms of fund flows," said Mark Sommer, who helps oversee about $29 billion of munis at Fidelity Investments in Merrimack, New Hampshire. "The market has built up resilience over the last several years to the difficulties faced by some of these high-profile credits."

Supply Slide

This month's diminished sales calendar is part of a yearlong slide in offerings, with supply 16 percent below the 2013 clip. States and cities are set to borrow about $21 billion this month, the least for July since 2001, according to Alan Schankel, a managing director focusing on muni research and strategy at Philadelphia-based financial-services firm Janney Montgomery Scott LLC.

The scarcity has helped fuel outsize gains. The municipal market has climbed 7 percent this year, its strongest start since 2009 and beating Treasuries and corporate bonds. The trend may extend into August as bondholders receive cash to reinvest.

Bond payments to investors, including cash from refinanced debt, will outpace issuance by about $6.5 billion next month, the most for August since 2011, said Peter DeGroot, head of municipal research at JPMorgan Chase and Co. in New York.

"Supply is nowhere near enough versus the cash flows," Tim McGregor, head of munis in Chicago at Northern Trust Corp., which oversees $30 billion of the bonds, said in an interview. "August supply won't pick up in a meaningful way."

Local Frugality

The dearth of debt helped push benchmark 30-year interest rates to the lowest since May 2013 this week, data compiled by Bloomberg show. Even with borrowing costs close to generational lows, municipalities are reluctant to issue as they grapple with fiscal strains left from the 18-month recession that ended in 2009.

States, counties and school districts are being “quite frugal with issuing debt,” said Terry Fettig, who manages about $150 million in munis as co-director of fixed-income investments at Windsor Financial Group LLC in Minneapolis. It’s challenging to find bonds for clients who want state-specific, high-quality credits, Fettig said.

“With rates where they are, I think it’s an opportune time” to borrow, Fettig said. “The second part of the year is going to be much more challenging.”

The consensus on Wall Street is that yields will rise this year as the economy strengthens. Interest rates on 10-year Treasuries will climb about 0.4 percentage point to 3 percent by year-end, according to the median forecast of 67 analysts in a Bloomberg survey.

Tax Fuel

Developments in Puerto Rico may still put the brakes on the rally. The island’s new debt restructuring law spurred one of six weeks of fund outflows in 2014. Junk-rated Puerto Rico has $73 billion in debt when counting its agencies, most of which is tax-exempt nationwide. In comparison, Detroit’s record bankruptcy last year tallied $18 billion.

In 2014, new tax laws are fueling investors’ appetite for local obligations. Some top earners faced levies on bond interest payments as much as 24 percent higher than in 2012.

“A lot of the credit worries exacerbated by Detroit and so on have receded,” said Schankel at Janney. “I don’t see investors as concerned about that. They want to buy tax-free bonds.”

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