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Tax-Free Rally Extended With August Supply Doldrums: Muni Credit.

The municipal-bond market's record winning streak shows no signs of slowing.

State and local debt has earned 0.8 percent this month through Aug. 18, on pace for the strongest August since 2011, Bank of America Merrill Lynch data show. Munis have gained each month this year, an unprecedented performance, pushing benchmark 10-year yields to the lowest since May 2013, according to data compiled by Bloomberg.

Slowing bond sales and sustained investor appetite have defined the $3.7 trillion market in 2014. This month is no exception: investors will probably face the skimpiest August calendar in three years, according to Chris Mauro, chief muni strategist at RBC Capital Markets. The issuance slump is helping munis defy forecasts that investors would lose money on tax-exempt debt in 2014.

"People have stopped holding their breath waiting for rates to go up, and that's one of the reasons why you're seeing demand continue," said Peter Hayes, head of munis at New York-based BlackRock Inc. (BLK) The world's biggest asset manager oversees about $122 billion in state and local debt.

Demand Feed

Sales have been in a yearlong decline, with supply 14 percent below the 2013 pace. States and cities will probably borrow about $22.4 billion in August, Mauro said. Meanwhile, investors will receive about $36.7 billion from principal and interest payments. Three years ago this month, municipalities sold $19.4 billion of debt, and the market earned 1.5 percent.

"The market feels fairly constructive even at these low rates," Mauro said from New York. "Supply looks exceedingly manageable."

This year is shaping up to be a reversal of 2013, which was the worst for munis since 2008 in part because of Detroit's record bankruptcy filing.

At year-end, analysts at Morgan Stanley and Barclays Plc projected rising interest rates and further losses in 2014. Citigroup Inc. strategists suggested selling in April, when 10-year AAA yields were at 2.4 percent, or about 0.2 percentage point above the current level.

Yields have dropped in the past month as cash flowing into muni mutual funds chased limited supply. Muni mutual funds added $648 million last week, the fourth-biggest inflow this year, Lipper US Fund Flows data show.

Tax Haven

There is little expectation that bond offerings will pick up. Research firm Municipal Market Advisors said in a report this week that it sees "thin prospects" for fourth-quarter sales. Janney Montgomery Scott LLC has said issuance will drop every year through 2017.

For some investors, lower yields are no deterrent. Even as there are fewer bonds to choose from, higher federal tax rates are boosting the appeal of munis' tax-free interest payments.

This year, high earners faced tax bills that for the first time included federal tax increases that took effect last year: a top marginal rate of 39.6 percent, up from 35 percent; and a 20 percent tax on long-term capital gains and dividends, up from 15 percent. The top tax bracket is the highest since 2000.

The increases coincide with a 3.8 percent tax on investment income applied to top earners last year as a result of the 2010 Patient Protection and Affordable Care Act.

With a peak federal tax rate of 43.4 percent when including the levy on investment income, the 2.18 percent yield on benchmark 10-year munis is equivalent to a taxable rate of about 3.9 percent. Ten-year Treasuries yield 2.4 percent.

The lack of supply "has led to the continued grab for bonds in the primary market and compression of spreads," said Joe Gotelli, who helps oversee $6 billion of munis at American Century Investments in Mountain View, California.

"Until a move in yields generates a change in perception that we're on the forefront of negative returns going forward, you could be in this environment for some time," he said.

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