Junk Bonds Prove September Treasure as Defaults Ebb: Muni Credit.

The riskiest municipal bonds are beating the market for the longest stretch in 20 months as investors bet a strengthening economy will keep defaults at the lowest in five years.

Speculative-grade debt gained 0.9 percent through Sept. 25, more than any other rating class, Bank of America Merrill Lynch data show. If that holds, it would mark the third-straight month that junk-bond returns have topped those of the broad market, which is little changed in September.

Defaults are set to be the fewest since 2009, according to data from Municipal Market Advisors. Industrial development bonds, the type of debt that represents the most failures to pay in the $3.7 trillion market, have been buoyed by rising capital-goods orders and employment gains. Land-backed debt, also prone to default, is benefiting from the highest level of new-home sales in more than six years.

"A combination of an improving economy helping credit risk and the opportunity for credit spreads to improve suggests high-yield could be a good place to put money right now," said Dan Solender, who oversees $16 billion as director of munis at Lord Abbett & Co. in Jersey City, New Jersey.

The U.S. economy expanded in the second quarter at the fastest pace since the last three months of 2011. Companies stepped up investment and households increased spending, the Commerce Department said Sept. 26. Gross domestic product grew at a revised 4.6 percent annualized rate, up from a previous estimate of 4.2 percent.

Following Money

Investors have added to high-yield muni mutual funds in each of the past 10 weeks, the longest stretch since the period through July 2, Lipper US Fund Flows data show. Those funds have gotten about half of 2014 inflows as individuals seek extra yield with interest rates near generational lows.

The demand has depressed yields on 10-year revenue bonds rated BBB, the lowest investment-grade tier, compared with AAA munis. The 0.95 percentage point spread is near the lowest since at least 2012, data compiled by Bloomberg show.

The penalty could decrease further. Before 2008, the average spread was 0.52 percentage point, Bloomberg data show.

"Spreads can probably go tighter — the economy has been growing and default statistics are rather low," said Lyle Fitterer, who oversees $34 billion of munis at Wells Capital Management in Menomonee Falls, Wisconsin. "Inflows have been positive, there's been limited issuance within the sector and there's just limited yield out in the marketplace."

Defaults Decline

Forty-one muni issuers defaulted for the first time in 2014 through Sept. 24, down from 45 last year and 67 in 2012, according to MMA, a Concord, Massachusetts research firm. The figure probably won't reach 2013's total of 65, the lowest since at least 2009.

Investors are also returning to high-yield funds as the likelihood of mass selling ebbs, said Solender and John Miller at Nuveen Asset Management.

Detroit is reaching settlements in its record bankruptcy, including an agreement with holdout Syncora Guarantee Inc., while Puerto Rico's cash-strapped power authority, Prepa, has hired New York-based turnaround firm AlixPartners LLP. That signals to investors that the market's biggest distressed situations are contained, Miller said.

"Their potential to have a contagion effect on the market has gone way down," said Miller, co-head of fixed income in Chicago at Nuveen, which manages $97 billion of munis.

Few Options

Ten-year Puerto Rico general obligations yield 6.32 percentage points more than AAA munis, Bloomberg data show. That's more than six times as much as benchmark BBB revenue bonds, signaling that investors including hedge funds are demanding an outsized penalty for securities from the island.

High-yield buyers avoiding Puerto Rico have had to turn to BBB rated debt because few issuers have offered speculative-grade or unrated bonds this year, said Jim Colby at Van Eck Securities Corp. He runs a $1.2 billion exchange-traded fund focused on junk-grade munis, the largest of its kind.

Willing Cash

Any high-yield bond sale "would find a lot of willing cash ready to support it," Colby said in a telephone interview. Individuals added $262 million to high-yield muni funds in the week through Sept. 24, the most in a month, Lipper data show.

"There continue to be positive inflows into our space and we see precious few new issues to take up the slack," he said.

Investors put in $7.6 billion of orders last month for Detroit's $1.8 billion of water and sewer bonds, which had junk ratings from Moody's Investors Service, according to the city. Issuers from California to New York found buyers this month amid the year's largest wave of bond offerings.

Munis broadly rebounded in the second half of September and may avert their first monthly loss of the year. The gains in 2014 have flummoxed investors and strategists. Some predicted interest rates would rise, when instead they have declined.

Federal Reserve Chair Janet Yellen has warned investors that the central bank may raise interest rates sooner than they currently project. Even in such a situation, riskier debt may prove a good bet, Miller said.

"High-yield helps provide more income and cushion returns should there be further interest-rate increases," Miller said. "There's an attractive income stream, and credit is broadly still on an improving trajectory."

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