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Squeeze on US Muni Sales Boosts Prices.

US states and cities have cut borrowing by 6 per cent so far this year as they rein in spending and tap other sources of funding for infrastructure projects and the maintenance of public services.

New issuance of "muni" bonds has been slowing in the past couple of years in the aftermath of the financial crisis, which ripped holes in municipal budgets.

In addition to fiscal austerity, a growing number of states and city governments in the US have been turning to partnerships with private entities – known as P3s – or tapping into direct credit lines with banks to meet their funding needs, analysts said.

"States and municipalities are generally doing a better job controlling their spending, and are not willing to embark on large projects while the economic outlook is still a bit uncertain," said Rob Taylor, head of municipal finance at Barclays.

"That, combined with the fact that there's been other sources of funding, such as direct bank lending, points to a drop in new issuance in 2014."

Sales of muni debt fell to $202.3bn through the end of September, down from $215.1bn in the same period of 2013, according to data from Thomson Reuters MMD.

Most of the sales' proceeds, or $57.2bn, was earmarked for general purposes, with funding related to education close behind, at $56.6bn. The state of California was the largest issuer of general obligation bonds, at $4.8bn, followed by the commonwealth of Puerto Rico, with $3.5bn.

For investors, the drop in supply has helped boost muni bond prices, which in turn has increased the total return on the securities.

Muni bonds have been one of the best performing assets so far this year, with average total returns on the debt at 8.1 per cent, according to Barclays indices. That compares with a total return of 4 per cent for US Treasuries and 7 per cent for investment grade corporate debt.

"There's no question about how the imbalance between the supply of new issues and demand has created a very favourable landscape for positive returns," said Jim Colby, chief municipal strategist at Van Eck Global.

"It's a compelling backdrop for many investors, specially when you also factor in some of the tax incentives attached to the securities."

As an incentive to invest in public projects and to keep borrowing costs low, interest income from munis is exempt from federal taxes. Many munis can also be exempt from state taxes and from local taxes too.

The allure of generous tax breaks is clear. An investor in a 35 per cent tax bracket would have to find a fully taxable security, such as a corporate bond, that yields more than 8 per cent to earn the same amount of income.

The strong performance in munis also comes after the worst year for the $4tn market in almost two decades and just one year after Detroit filed the biggest municipal bankruptcy case in US history.

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By Vivianne Rodrigues in New York

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