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WSJ: U.S. Muni-Bond Market Is on a Tear.

The Tax-Favored Debt Has Outperformed Corporate Bonds, Treasurys in 2014

The debt issued by U.S. cities, states and local entities such as sewer systems has posted its longest string of monthly gains in more than two decades in 2014, outpacing gains in corporate bonds and U.S. government debt, according to data from Barclays PLC.

Investors are flocking to the $3.6 trillion municipal-bond market at a time of low interest rates, uneven global growth and concern that the nearly uninterrupted rise in many stocks and bonds since the financial crisis will come to an end. The debt is especially attractive because interest payments typically don't generate federal taxes and, in some cases, aren't subject to state taxes.

That foundation, along with forecasts for relatively flat issuance of new bonds, is expected to support the rally in 2015 despite concerns about the impact of an increase in short-term interest rates by the Federal Reserve, which many economists and investors expect in the middle of next year. The fiscal woes of state and local governments are also a lingering worry.

"The U.S. muni market lurches between extended periods of tranquility and abrupt interludes of instability," said Thomas McLoughlin, co-head of fundamental research at UBS Wealth Management Americas. "And the story of 2014 is this has been an extended period of relative tranquility."

The gains in every month of 2014 have more than reversed the sector's pullback last year, amid Detroit's record bankruptcy, Puerto Rico's financial straits and concerns about higher interest rates. Some observers warned that municipal bonds were vulnerable to an investor exodus, echoing a sentiment that pervaded the market after the 2008 financial crisis.

Instead, municipal bonds have returned 8.71% this year through Friday, including price gains and interest payments, according to Barclays. That compares with a total return of 15.3% for the S&P 500, 6.97% for highly rated corporate debt and 4.6% for U.S. Treasury debt.

The broad debt-market rally that upended Wall Street bets on rising interest rates in 2014 also fueled a surge of investor funds into municipal bonds, many of which are considered as safe as Treasurys because they are backed by tax revenue. Yields on municipal bonds fell to a two-year low of 1.94% in mid-October, according to Barclays data. Yields fall when prices rise.

Investors, led by individuals purchasing the debt through mutual funds, have poured $23.9 billion into municipal-bond funds through mid-December, according to Lipper. They withdrew $63.5 billion last year.

Low overall borrowing by belt-tightening public officials in cities and states through the first three quarters of the year reduced the supply of new bonds, while higher tax rates increased the relative attractiveness of tax-exempt debt, said Daniel Solender, director of municipal-bond management at Lord Abbett & Co., which oversees about $16 billion.

Despite a late-year increase in bond issuance and the prospect of the Fed raising rates, yields on municipal debt still look attractive, he said.

In the first quarter of the year, cities and states borrowed about one-quarter less than they did in the same period of 2013, according to data from the Securities Industry and Financial Markets Association. Municipal-bond issuance totaled $295.8 billion through November, about 4% less than in the same period last year.

“When you look at supply, which picked up for us in the fourth quarter, there are still more bonds being called out of the market than being issued, so that creates some demand,” Mr. Solender said.

The supply of bonds isn’t likely to surge in 2015. A SIFMA survey of municipal-bond underwriters and dealers this month predicted issuance will reach $357.5 billion, compared with a total of $348.1 billion forecast for 2014.

At the same time, demand from individual investors, mutual funds and banks and insurance companies has remained robust, said Ashton Goodfield, co-head of the municipal-bond department at Deutsche Asset & Wealth Management, a unit of Deutsche Bank AG . That has helped investors overcome last year’s fears about losses from Detroit or Puerto Rico. The U.S. commonwealth passed a law in June allowing some public agencies to restructure their finances.

“I think people are understanding that there’s not going to be a rash of bankruptcies in the market,” Ms. Goodfield said. “It’s a confirmation that municipal credits are generally solid.”

Some analysts said hedge funds and other distressed-debt investors have assumed much of the risk from Puerto Rico, which has about $73 billion in total debt. Hedge funds were the primary buyers in a March $3.5 billion bond sale. Puerto Rico’s cash-strapped electric-power authority owes about $9 billion and appointed a chief restructuring officer in September.

Investor concerns over municipal pension obligations, however, may become more apparent in the new year, leading some to avoid states with large funding gaps such as Illinois, said Tim McGregor, director of municipal fixed income at Northern Trust in Chicago, which manages about $30 billion.

“Many places have done good work on pension reform, but those that are lagging will continue to be under the microscope,” Mr. McGregor said. “I expect the market will begin differentiating a little more.”

An unexpected jump in interest rates could also slow the rally in 2015, said Chris Mauro, head of U.S. municipal strategy at RBC Capital Markets. A new Congress could also take up tax reform, introducing unforeseen changes to the municipal sector, breaking through a widespread perception of Washington gridlock.

“As we learned in 1986, large-scale tax reform is extremely unpredictable,” he said.

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