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Munis Face 2015 Headwind as Record Market Contraction Set to End.

After the biggest annual gain since 2011, municipal debt faces a headwind in 2015 as the $3.6 trillion market is projected to expand for the first time in five years.

An era of austerity that swept through local government may be subsiding more than five years after the recession. Bond sales will swell 15 percent to $354 billion this year, which would exceed the amount flowing back to investors from debt payments and refinancings by $46 billion, according to Michael Zezas, chief muni strategist in New York at Morgan Stanley.

That would halt an unprecedented four-year market contraction and ease the scarcity that helped munis outperform Treasuries and corporate debt in 2014. Bank of America Merrill Lynch, Janney Montgomery Scott, Loop Capital Markets and Morgan Stanley project that returns in 2015 will fall from last year's 9.8 percent gain.

Positive net supply "removes something that was a clear support for the market," Zezas said in a telephone interview. "It's hard to forecast the demand side of the equation getting more supportive than it already is."

Ownership Sway

Individuals own the majority of the municipal market either through specific bonds or mutual funds, giving them outsize sway over the asset class's performance. Last year, they poured $21 billion into muni funds, according to Lipper US Fund Flows data, and state and local debt returned the most since an 11.2 percent gain in 2011. In 2013, they yanked about $63 billion amid a 2.9 percent loss, the worst since 2008.

Throughout both periods, new issuance failed to catch up to the wave of cash bondholders got back from refinancing and debt payments. That dynamic, known as net negative supply, creates demand for munis, assuming investors want to roll the money back into state and local debt.

From 2011 through 2014, bondholders got more money back from their debt than the amount of new deals from states and cities, causing the market to shrink by about 4 percent as of Sept. 30, according to Federal Reserve data.

Munis' advance last year compared with 7.5 percent for investment-grade corporate bonds and 6 percent for Treasuries, according to Bank of America data.

In his 2015 outlook, published last month, Zezas estimated munis will earn 1.14 percent.

2015 Maturities

In 2015, the amount of maturing debt is set to drop to $176 billion from $282 billion, curbing that source of payment to investors, data compiled by Bloomberg show.

States and cities have hesitated to borrow since the 18-month recession ended in June 2009, avoiding the added cost of paying back bondholders. The decline in principal payments in 2015 is a reprieve for municipal budgets because they require more cash than interest does.

The easing debt expenses, combined with strengthening budgets and interest rates close to generational lows may spur lawmakers to borrow before yields rise, said Chris Mier, chief municipal strategist at Loop Capital in Chicago.

"You could see a modest increase in volume from issuers that assume the era of very low rates might be coming to an end and therefore it's time to begin some new infrastructure projects," Mier said via telephone.

Project Demand

The median forecast for 10-year Treasury yields at year-end is about 3 percent, almost 1 percentage point higher than now, according to a Bloomberg survey of 74 analysts.

Benchmark 10-year muni yields fell below 2 percent today for the first time since October, Bloomberg data show. They ended last year at 2.11 percent.

In a sign of the pent-up demand among lawmakers for new projects, U.S. states and localities asked voters in November to approve $44 billion of bonds for schools, water systems, hospitals and roads, more than twice what they sought in 2010.

Voters approved more than $37 billion of the measures, according to Ipreo, a New York-based financial-market data provider.

"If the muni market does not grow, then this country is in trouble," said Phil Fischer, head of muni research at Bank of America in New York. "You don't just add paint to a bridge — if you don't replace the metal, it will fall down."

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