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Muni Junk Bonds Are Outperforming Other High-Yield Options.

Investors are finding an unlikely haven amid the rout in corporate junk bonds: their tax-exempt counterparts sold by municipalities.

The riskiest local-government bonds returned 2.9 percent through Sept. 29, heading for their best month since August 2014, Bank of America Merrill Lynch data show. That's more than four times the gain in the broader municipal market and stands in contrast to the shift away from debt sold by struggling businesses. High-yield corporate securities have lost 2.7 percent this month.

"People are looking for income streams, and at the same time they want some level of safety," said Dan Heckman, senior fixed-income strategist in Kansas City, Missouri, at U.S. Bank Wealth Management, which oversees about $127 billion of assets, including high-yield municipal bonds. "They view the high-yield muni as a little safer place out of other risk areas that contain higher yields."

After the Federal Reserve decided not to raise interest rates at its Sept. 17 meeting, money flooded into mutual funds focused on high-yield municipals. The funds pulled in $178 million in the week ended Sept. 23, the first in a month, Lipper US Fund Flows data show.

The municipal bonds, which are sold for specific projects or by strained governments such as Puerto Rico and Chicago, have skirted the turmoil in other financial markets over the past two months, when stocks tumbled amid speculation that the world's economy will slow.

Their relative security has been a draw to investors seeking to ride out the volatility, said Heckman. High-yield munis had a default rate of 7.5 percent over the last decade, compared with 32 percent for comparable corporate debt, according to a July 24 report from Moody's Investors Service.

The recent gains stem the losses that came this year as Puerto Rico's fiscal crisis escalated. The commonwealth defaulted on some securities for the first time in August and plans to ask investors to restructure debt that Governor Alejandro Garcia Padilla says the government can no longer afford.

The default didn't trigger an exodus from the municipal-bond market because the long-brewing crisis is seen as limited to the island. After initially pulling money from high-yield funds amid speculation about the potential ripple effects, investors have been adding money back, seeking higher yields as interest rates hold near generational lows.

With "the low-rate environment, there's demand for incremental yield," said Dan Solender, who helps manage $17 billion as head of state and local debt at Lord Abbett & Co. in Jersey City, New Jersey. "The credits have been holding in well. There's not been significant issues so the credits are performing well.'

Chicago bonds, which were cut to junk by Moody's in May, have pared their losses as Mayor Rahm Emanuel proposed a record property-tax increase to help cover the city's rising pension-fund bills.

Federally taxable Chicago bonds maturing in 2042 traded Wednesday for an average of $1.02 on the dollar, up from 96.7 cents on Aug. 31.

Puerto Rico securities have also rebounded since June. Garcia Padilla's administration plans to ask investors to voluntarily exchange their securities for new ones with lower interest rates or longer maturities, a process that could shelter some bondholders from losses. Puerto Rico debt maturing in 2035 traded for an average of 74 cents on the dollar Wednesday, up from as little as 64 cents on June 30. That pushed the yield down to 11.2 percent from 13.1 percent.

"The Puerto Rico influence in the high yield indexes could be as much as 20 percent," said Jim Colby, who manages about $1.6 billion of high-yield municipals at Van Eck Global in New York. "So that I think it is a very significant element of why we've had such good performance."

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