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Muni Market Proving Haven for Buyers of Junk Issuers Amid Rout.

The corporate junk-bond rout loses its force when it comes to the U.S. municipal-debt market, where investors are snapping up securities backed by financially struggling businesses.

Consider the steel industry. Local-government bonds sold on behalf of U.S. Steel Corp., the nation's second-largest producer, trade for more than 100 cents on the dollar, even after its corporate debt tumbled 17 percent since mid-July to 83 cents, according to data compiled by Bloomberg. Rival AK Steel Corp.'s munis trade almost 40 cents higher than its other securities.

The diverging prices highlight a disconnect in the high-yield market: While the corporate bonds had their biggest loss since 2011 during the third quarter, the tax-free debt rallied. That's because money has been flowing into muni funds over the past two months as yields slid to the lowest since April, igniting demand for the riskiest securities.

"People can argue it's way out of alignment in terms of the absolute levels on corporates these days," said Jim Colby, who runs the $1.6 billion Market Vectors High Yield Municipal Index exchange-traded fund at Van Eck Global. He attributed the gap to the lack of munis available. "If you want these bonds, you have to pay the price."

The corporate securities are a niche of the $3.7 trillion muni market, where state and local governments can sell bonds to subsidize airline terminals, pollution-controls for factories and other projects that are seen as having a public benefit. The companies repay the debt, which isn't guaranteed by the governments. About $25 billion of fixed-rate, federally tax-exempt economic and industrial-development bonds have been issued, according to data compiled by Bloomberg.

There has been a dearth of them lately. Only $299 million of the industrial-development securities were sold this year. By contrast, businesses have issued $1.7 trillion of new speculative-grade corporate bonds in the past five years, a binge that's fueled speculation that more borrowers will default if the U.S. economy slows.

U.S. Steel's munis, issued through agencies including Pennsylvania's Allegheny County Industrial Development Authority, have been largely sheltered from the losses felt by corporate-bond holders as the company faces pressure from declining prices and competitors abroad.

Prices Diverge

Among transactions over $1 million, securities due in 2024 traded Thursday at 103 cents on the dollar to yield 6 percent — equivalent to 10.6 percent on a taxable bond for the highest earners. The debt fell from 107 cents in previous exchanges at the end of September.

While the current price is down 8 percent from July, the company's corporate debt fell even more: Bonds due in 2022 last changed hands at 83 cents, down from par three months ago. That pushed the yield up to 11.4 percent.

AK Steel munis also due in 2024 last traded at 89 cents on the dollar. While that's down from about 100 cents in July, the company's taxable debt maturing in 2022 changed hands at 52 cents.

"We're seeing the spreads on those types of corporate names in our market widen out," said Steve Czepiel, who runs a $997 million high-yield muni fund for Delaware Investments in Philadelphia. "There may be a buying opportunity where they're just being yanked around by their corporate counterparts."

Moody's Investors Service rates AK Steel's senior unsecured debt, including the munis, Caa1, the fifth-lowest grade, signaling a high risk of default, and put it on review for downgrade on Oct. 8. Similar securities from U.S. Steel are ranked B1, four levels below investment grade. Shares of both companies have fallen this year to their lowest levels since 2003.

Such muni bonds aren't exempt from the risks faced by other investors. When American Airlines parent AMR Corp. declared bankruptcy in 2011, the tax-exempt securities it backed dropped as much as 68 percent. Two years later, the bonds rallied to above 100 cents from as low as 18.9 cents as American merged with US Airways Group Inc.

Other companies that have borrowed through the muni market include Alcoa Inc., Marathon Oil Corp., NRG Energy Inc., Southwest Airlines Co. and Westlake Chemical Corp., Bloomberg data show. All of their debt is either speculative grade or in the lowest investment-grade tier.

Louisiana Oil

Marathon tax-exempt bonds due in 2037 from Louisiana's Parish of St. John the Baptist traded this week at an average 102.4 cents on the dollar, down about 2 cents from July, Bloomberg data show. By contrast, corporate debt with a similar coupon that matures in 2045 changed hands at 88.5 cents, compared with an average of 96 cents three months ago. Moody's rates Marathon three steps above speculative grade. Its stock has dropped 33 percent this year.

Tax-exempt investors are willing to take the risk as the Federal Reserve keeps its benchmark lending rate near zero. Almost half of the Barclays Plc high-yield muni index is made up of Puerto Rico and tobacco securities, both of which are at risk of default. That's leaving bonds tied to some of the largest U.S. corporations as an alluring alternative.

"The most important thing to the muni-bond buyer is the after-tax return," said Ken Naehu, a managing director at Banyan Tree Asset Management in Los Angeles. "The taxable guys are looking more at dollar price and recovery risk."

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