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U.S. Muni Bonds Unlikely Home For the Huddled Masses.

Could the almost 6m daily passengers on New York's subway system prove the unlikely beneficiaries of the ever growing universe of negative-yielding bonds?

It is not as far fetched as it sounds. Foreign investors are buying increasing amounts of the municipal bonds sold by US states and cities to fund public works and infrastructure projects.

The introduction of negative rate policies by the European Central Bank and the Bank of Japan, analysts and investors say, is further sharpening overseas interest in an asset class that historically has been the preserve of US buyers who are not required to pay tax on the income from municipal bonds.

"There is a real demand for yield," says Christopher Molumphy, chief investment officer of fixed-income at Franklin Templeton. "We've had some foreign buying into US municipals, which I was surprised about when I first heard because they don't benefit from the tax treatment."

Foreign investors still represent a tiny share of the $3.7tn market. Foreign investors held $85bn of the debt at the end of last year, up from $80bn a year earlier and $29bn in 2005, the latest data from the Federal Reserve show.

However, with almost $10tn of bonds globally carrying negative yields, according to Fitch, and corporate bonds in the US and Europe rallying hard, many expect the buying to accelerate.

"We're probably in the first inning of the foreign investor game," argues Mikhail Foux, a specialist in municipal bonds at Barclays in New York. "We're seeing some money put to work but it is a small portion. Over the next six to 12 months well see more of that happening."

Fresh foreign buyers are helping to fan an existing rally in municipal bonds that has drawn impetus from a dearth of supply as US cities and states refrain from borrowing.

The yield on 10-year municipal bonds dipped below 1.7 per cent on Wednesday, less than one basis point above a record low touched this February as the asset class was buoyed by the sell-off in riskier assets. Bond yields move in the opposite direction to prices.

The benchmark ten-year US government bond yields 1.73 per cent, a result of the differing tax treatments. By contrast, similar German, French and Swedish sovereign debt offers less than 0.5 per cent, while shorter-dated bonds from the countries carry a negative yield.

Against a backdrop of wider market volatility — and still fragile sentiment towards riskier assets — muni bonds are continuing to lure US investors. Mutual funds and exchange traded funds that invest in municipal bonds have recorded 31 straight weeks of inflows, with $19.5bn of fresh capital pouring in, Lipper data shows.

"Flows have been very heavy," says Mark Paris, who runs Invesco's high-yield municipal bond fund. "Supply . . . is now clearly down. The technicals are overwhelming. There have been deals that have been seven-times oversubscribed because so much money has come into the space.”

It is a rally that has made munis expensive, according to Thomas McLoughlin, head of municipal research at UBS Wealth Management Americas, who cautions that interest from foreign buyers is still nascent.
California and New York have been among the borrowers to benefit, with a $1.4bn offering last month from the Golden State attracting “strong bids,” says Alan Schankel, a municipal bond analyst at Janney Montgomery Scott.

However, those high-profile sales stand out as activity has slowed. Sales this year, at $138bn, are more than 10 per cent lower than the same period in 2015 as fewer issuers refinance, according to Thomson Reuters.

Then there is the politics. Despite an improved revenue picture at the state and local level the need to retrench during the financial crisis of 2008- 2009, when states suffered steep losses to their tax bases, has left a hangover.

“There’s a political stigma with taking on more debt,” says Genevieve Nolan, an analyst with Moody’s.
The looming presidential election is also diminishing the appeal of issuance to local and state politicians grappling with pension reforms, new healthcare programmes and — in states such as Alaska, Texas and Oklahoma — the drag on their finances from lower energy prices.

Natalie Cohen, head of municipal research at Wells Fargo, and Mr Foux of Barclays expect supply to climb after the election in November. Constitutional provisions in many states require voters to approve certain debt sales — most often concerning the issuance of general obligation bonds — a point that will be watched by underwriters as state and local elections near.

States and cities lack of appetite to tap the municipal bond market this year comes as the chronic lack of investment in America’s infrastructure climbs up the national agenda as a range of events, including a polluted water scandal in Flint, Michigan and problems with DC’s metro system, force attention on the issue. Presidential frontrunners Hillary Clinton and Donald Trump have called for investment in US infrastructure.
Investors are already casting their attention to potential funding for large projects, like the reconstruction of LaGuardia Airport and multibillion-dollar financing needs of New York’s transportation authority as it constructs its new Second Avenue subway.

If the trend continues, money escaping negative yields in the eurozone and Japan may ultimately help fund such ventures. As Ms Cohen of Wells Fargo says, “Even if [foreign investors] are not subject to the US tax code, a plus two is better than a minus one. It’s just basic math and that has made municipals attractive.”

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by Eric Platt in New York

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