Bond Case Briefs

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U.S. Municipal Debt Draws Rush of Investors.

Cash has poured into muni-bond mutual funds this year, sending yields down to near-record lows

Investors are buying municipal debt at a record clip, enduring low returns in exchange for the relative stability of bonds sold by U.S. state and local governments.

Municipal-bond funds had more than $632 billion in assets as of June 1, a record high, according to Lipper data going back to 1992. Investors have poured a net $22.5 billion into such mutual funds in 2016 through Wednesday, the best start to a year since 2009. They have pulled $39.97 billion from equity funds in the same time.

The buying is being spurred by ongoing concerns about the slow pace of global growth and the prospect of interest rates staying lower for longer, concerns boosted by Friday's weak jobs report.

In addition, low—or negative—yields on government bonds world-wide have made munis increasingly appealing relative to other fixed-income assets. The amount of municipal debt held by foreign investors increased 44% to $85 billion from 2009 through 2015, according to Federal Reserve data.

Munis also provided a haven for investors during sharp swings this winter in the equity and high-yield corporate-bond markets. And years of price appreciation in munis have left investors hungry to snap up new issues.

Enthusiasm for the debt has driven prices in the roughly $3.7 trillion market so high that yields have fallen to near-record lows. The enthusiasm comes even as Puerto Rico is defaulting and concerns persist about the financial health of some cities and states. In addition, U.S. interest rates are still expected to rise this year, which can hurt the value of outstanding bonds.

Investors prize munis in general because they are considered nearly as safe as Treasurys, backed by tax revenue or fees on critical public services, such as water. The debt also offers interest payments that are typically free from federal taxes. In the years since the financial crisis, the highest-rated municipal bonds have often yielded more than Treasury debt. But that trend has begun to reverse in recent months, intensifying some analysts' concerns about the risks of purchases at current prices.

Yields "aren't all that attractive anymore, yet we continue to see inflows into the funds," said James Kochan, chief fixed-income strategist at Wells Fargo Funds Management. "It doesn't take much to produce negative returns from these levels."

Yields on the Barclays Municipal Bond Index fell to a record low of 1.75% in mid-May and were at 1.83% on Friday.

Municipal bonds have returned 2.89% so far this year, counting price appreciation and interest payments, according to Barclays PLC as of Friday. That compares with 3.88% for Treasurys, 6.14% for highly rated corporate debt and 8.09% for junk bonds.

Rick Taormina, head of municipal strategies at JPM Asset Management, said some investors have been experiencing "rate shock," surprised by the low yields even on longer-dated or less-creditworthy debt.

Despite such low yields, the hazards of municipal bonds—including hundreds of millions in defaults from Puerto Rico—seem mild compared with the year's swings in stocks and other riskier assets.

The supply of new bonds has fallen, helping to drive up prices. Government borrowers have issued $170 billion of bonds from the beginning of 2016 through June 1, down 4.2% from the same period of 2015, according to Thomson Reuters data.

"When there's less volume, there's more money chasing after fewer and fewer bonds," said Howard Cure, director of municipal research at Evercore Wealth Management. "I think a lot of governments are still getting over how tight their finances were just a few years ago."

For cities and states that do borrow, costs have fallen. Connecticut, which was recently downgraded to double-A-minus by two ratings firms amid concerns about the state's budgetary flexibility, last month sold 10-year bonds yielding 2.33%, down from a yield of 2.75% on 10-year debt the state sold a year ago, notes Matt Fabian, partner at the research firm Municipal Market Analytics.

Despite the threat of higher interest rates, few are predicting a major pullback in munis this year. Analysts said that Puerto Rico's defaults have had little impact on the broader market. And the tax break provided by municipal bonds helps offset the low yields the debt currently offers.

John Miller, co-head of fixed income at Nuveen Asset Management, which manages about $113 billion in state and local debt, said the imbalance between demand for the debt and the supply of new bonds is likely to keep prices high in the short term, even if the Fed raised rates.

"There's a bit less fear around the implications of that," he said. "Even though munis are at low yields relative to history, they're at high yields relative to the rest of the world."

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