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June, Usually the Cruelest Month for Muni Bonds, Is Anything But.

A flood of state and local government debt in June wasn't enough to dampen a rally in the municipal-bond market.

While states and local governments sold $44 billion fixed-rate bonds, more than any month since October 2010, the securities returned 1.6 percent, buoyed by steady investor inflows and a flight to the safest assets amid speculation about impact of the U.K. vote to leave the European Union.

It was the best June performance since 2000 and the market's biggest advance since January 2015, according to a Bank of America Merrill Lynch index. In a sign of the market's strength, 30-year yields declined 0.15 percentage point the day after England's June 23 referendum, slightly more than Treasuries. At 3.18 percent, the Bond Buyer's 20 Year General Obligation Bond Index is at its lowest since May 1965.

"We're talking about massive issuance and nevertheless deals have been vastly oversubscribed, at least until now," said Mikhail Foux, head of municipal strategy at Barclays Plc. "People just can't get enough despite rates actually falling."

Historically, June has proven to be a weak time for the local bond market because it has the heaviest supply of new bonds. The Bank of America Merrill index has posted positive returns in the month only three times since 2006.

Macroeconomic forces this year combined to push up prices instead. June began with a disappointing jobs report that showed employment growth was the lowest in five years, weakening the case for the Federal Reserve to raise interest rates. It ended as investors took shelter from the fallout from the so-called Brexit. In between, the Fed's statement that inflation remains below its 2 percent target stimulated demand for longer-dated bonds.

U.S. state and local-government debt funds have taken in cash for 39 straight weeks, according to Lipper US Fund Flows data, the third longest streak. Even before the U.K.'s vote triggered turmoil in markets worldwide, the funds picked up $1.4 billion in the week ending June 22, the most since January 2013.

Foreign buyers, faced with negative interest rates in their own countries, are contributing to the flood of cash.

With yields at a more than 50-year low, such inflows may be curtailed if investors start looking elsewhere for higher returns, said Matt Dalton, who oversees $5 billion of munis as chief executive officer of Rye Brook, New York-based Belle Haven Investments.

"There's just not as much meat on the bone," Dalton said. "When you're at a low yield level like we are, at some point you just run out of gas."

The only part of the muni yield curve that has slightly underperformed is the short-end, said Foux.

Investors should add short-dated bonds and hedge them with Treasuries, he said. Short-dated New Jersey general obligation and appropriation-backed bonds and Detroit Public School bonds are attractive as is zero-coupon debt.

In July and August, the strength of the $3.7 trillion market may continue as issuance declines and bondholders reinvest debt payments and proceeds from callable bonds. Nuveen Asset Management forecasts $48 billion will be reinvested in July and $44.5 billion in August, compared with issuance of $39 billion and $37 billion, respectively.

Since the beginning of the year, munis have returned 4.3 percent, or 6.2 percent on a tax-adjusted basis, according to Barclays. That's better than the 5.4 percent return for Treasuries. The S&P 500 has gained about 2.7 percent.

"All those features in terms of tax exemption, the yield, and negative correlation to equities have attractive characteristics, so they keep putting money to work and that money is coming in globally as well," said John Miller, co-head of fixed income in Chicago at Nuveen, which oversees $120 billion of munis.

After Brexit, the Fed likely won't raise interest rates for the rest of the year, eliminating a risk to the value of outstanding fixed-income securities, Miller said.

Meanwhile, a victory by Democrat Hillary Clinton in the presidential election would also support municipal bonds because she would likely raise taxes, increasing the value of the tax exemption, said Foux. Conversely, a Trump victory would hurt.

"For the most part, I see the market being supported near term," Foux said. "It's a defensive asset class. It should perform well in times of stress."

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