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Japanese Investors So Desperate for Yield They'll Buy U.S. Munis.

Tetsuo Ishihara, a strategist for Mizuho Securities in New York, started fielding phone calls a couple months ago from Japanese clients interested in U.S. municipal bonds, which usually have little allure overseas because federal tax breaks depress the yields.

But with negative interest rates on Japanese bonds due in as many as 10 years and near record-low payouts on Treasuries, he discovered that state and local debt demanded attention. Even highly rated municipals are delivering bigger returns than U.S. government bonds, without the risk that comes with corporate securities.

"The risk return looks pretty good," said Ishihara, U.S. macro strategist for the Tokyo-based brokerage, who sent clients a report in September showing how municipals stacked up favorably against other fixed-income investments. "The default rate for munis is much lower than for corporates. All that fits with what they need."

Increasingly, investors outside the U.S. are contributing to the cash that's flowed for a year into the $3.8 trillion municipal market, which caters largely to Americans willing to accept low yields because the income is exempt from U.S. taxes. By the end of June, foreign buyers had increased their holdings of the securities to $89.7 billion, about triple what they held a decade earlier, even though they don't get any of the tax benefits.

Investment firms have courted the business. Shinsei Bank Ltd. and Western Asset Management, a unit of Baltimore-based Legg Mason Inc., last year started a private fund that invests in municipals for Japanese financial institutions. In March, Eaton Vance Management's co-director of U.S. tax-exempt bonds was among those who spoke at an investment forum the firm co-sponsored in Tokyo.

Columbia Threadneedle Investments got its first account from Japan about a year ago and within six months anticipates that it will have at least $200 million from insurers, diversified financial companies and other clients in Asia, said James Dearborn, head of tax-exempt securities at the Boston-based firm. The funds are primarily invested in taxable municipals, which carry higher yields.

"They've come to like the idea that munis represent a relatively stable asset class and that the default incidence is very, very low for a long period of time," said Dearborn, whose firm manages $24 billion in state and local debt. "They're creating demand we didn't have before, and that's a good thing."

U.S. municipal bond funds have pulled in money for 52 weeks straight, the longest stretch since 2010, according to Lipper US Fund Flows. Such demand pushed municipal yields to the lowest on record by early July, before they edged back up amid speculation that the Federal Reserve will resume raising interest rates as soon as December.

Even with the influx of funds, 10-year municipal revenue bonds with an AA rating yielded about 1.94 percent by the end of trading Wednesday, or 0.23 percentage point more than Treasuries, according to data compiled by Bloomberg.

Dearborn and Ishihara expect the interest to remain strong, regardless, as investors look for havens from equity-market swings and central banks around the world hold yields near zero. After Ishihara published his report, Japanese clients peppered him with questions, showing they had already been looking closely at the market.

Considering the environment of low rates and inflation, “the credit cycle could last maybe more than two years,” he said. “It could continue for a while.”

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