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Investors Sense Opportunity in One Corner of the Money Markets.

A reform-driven rise in short-term borrowing costs is focusing attention on an often-overlooked corner of the market: municipal debt.

Three-month AAA munis are offering the equivalent of about 1.3% in taxable yield when adjusting for those who would ordinarily pay the top income tax rate, according to Ned Davis Research Group. By comparison, buying U.S. Treasury debt for five years would offer a lower annual yield of 1.24%.

Municipal borrowers, who typically issue tax exempt debt to finance state and local projects, are paying higher rates to borrow thanks to new money market reforms that went into effect last week. Prime money market funds now have the ability to charge redemption fees or stop withdrawals during times of market turbulence.

In anticipation of those reforms, investors pulled hundreds of billions of dollars from prime funds, which typically invest in high-grade corporate or municipal debt. More than $100 billion fled municipal money market funds specifically, according to Pacific Investment Management Co.

Lower demand from that traditional buyer has led to higher short-term borrowing costs for municipalities. But many are also looking at it as an opportunity, echoing, and at times exceeding, investor excitement over short-term corporate debt that has also offered higher yields due to money market reform.

The new buyers include taxable money funds, separately managed accounts, hedge funds, and longer-term bond funds, according to Colleen Meehan, the director of municipal money market fund strategies for BNY Mellon Cash Investment Strategies.

“The beauty of that product is that they can move up rates to entice non-traditional buyers,” she said. “And that’s exactly what has happened.”

The yields look attractive to those investors in an otherwise low-rate world. The yield on three-month Treasury notes, for example, was recently at 0.33% Friday.

Another benchmark for municipal yields, the SIFMA Municipal Swap Index, was recently at its highest since the financial crisis, according to Pimco. Variable rate demand notes, which have rates that float, are typically reset based on the swap index rate, making them and other floating-rate instruments attractive buys, Pimco said in research this week.

The amount of outstanding VRDNs surpassed the amount of money in municipal money-market funds in recent months, a sign that new buyers are stepping into the space to replace those which are leaving, according to Ms. Meehan.

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