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Municipal Debt Lures Yield-Hungry Investors in Second Quarter.

Bond inflows this year show that investors view public debt as a safe way to make money

For evidence of investors' appetite for municipal debt, look no further than New Jersey.

That is where delays have plagued the planned megamall American Dream for more than a decade. Nevertheless, investors last month flooded into unrated public authority bonds designed to revive the 2.9 million-square-foot project.

The $1.1 billion offering, which promised returns of as much as 6.86%, is a sign of how hungry investors are for new municipal debt despite mounting fiscal problems in some cities and states around the country.

Buyers have snapped up nearly $88 billion in new public bonds this year through Friday, up 8% from the same period last year, according to Thomson Reuters. That happened as annual borrowing by local governments rose to a seven-year high.

It also comes as ratings firms have downgraded Illinois and Hartford, Conn., to the brink of junk status, and the troubled U.S. territory of Puerto Rico was placed under court protection as a way of sorting through its mountain of liabilities.

"The market is able to take these individual events in stride," said John Miller, co-head of global fixed income at Nuveen Asset Management.

The demand for new bonds is driving down costs for government borrowers and making existing debt more expensive for investors. The S&P Municipal Bond Index gained 3.25% year to date through Friday.

One high performer was a bond issued by the Harris County Sports Authority to refinance Houston's NRG Stadium. It returned 20.7% during the second quarter through Thursday, according to bondholder Nuveen Asset Management.

The same authority struggled during the latest recession with soured debt deals, a cash crunch and ratings downgrades. But it has now been able to set aside enough money to repay the bonds, making them more valuable.

Many investors still view public debt as a relatively safe way to make money because municipal defaults are rare and states aren't allowed to seek bankruptcy protection. But some observers say they see greater potential for losses as public expenses rise.

"Risk in the municipal market is building," said Matt Fabian, a partner at Municipal Market Analytics, in a recent note.

The performance of the municipal-debt market in 2017 is a surprise to many observers, who expected a pullback following the election of President Donald Trump. The S&P Municipal Bond Index fell 3.46% last November largely because of expectations that tax cuts and higher inflation would reduce the value of tax-exempt debt, analysts said.

About $27 billion flowed out of municipal-bond mutual funds and exchange-traded funds during the last two months of 2016, according to the Investment Company Institute.

But those outflows reversed at the start of 2017 as tax cuts and higher inflation looked less likely in the near term. Inflows have totaled $15 billion so far in this year. Lower inflation expectations typically give investors confidence that the debt will retain its value.

“People got more comfortable with the fact that tax reform is not going to happen anytime soon,” said Triet Nguyen, a managing director at New York-based NewOak Capital, a research and advisory firm.

A drop in municipal-bond refinancing combined with an increase in debt coming due during 2017 have also driven up bond prices as investors look for ways to use their cash, analysts said.

“Despite the Illinois and Connecticut headlines, munis have performed just fine,” added J.R. Rieger, managing director of Fixed Income Index Product Management at S&P Dow Jones Indices, LLC.

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