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[Political Stalemate Buoys Municipal Bonds.]

Relatively scant issuance this year also helps the market for city and state debt

Inaction in Washington has been a boon for municipal-bond investors this year.

In the two months after the 2016 election, investors took $27 billion out of muni-bond funds. The fear was that President Donald Trump's agenda for taxes, infrastructure and health care would drive up interest rates, and thus make outstanding bonds less attractive.

Washington has made scant policy changes, and those concerns have since abated. In addition, the GOP tax framework leaves the tax-deductibility of municipal bonds intact. In short, little has changed, and investors are again doing what they had done in previous decades: buying munis.

"So far this year has been very good for returns for munis, and somewhat unexpectedly," said Jim Colby, senior municipal portfolio manager at VanEck.

Also driving up prices: Cities and states have so far issued much less debt than last year, leaving investors hungry for municipal bonds.

Though prices have drifted downward slightly over the past month alongside Treasurys, the S&P Municipal Bond Index is back to its pre-election level, 4.4% higher than at the beginning of January.

In trading this month, a New York state general-obligation bond carried a yield of 1.2%, compared with 2.1% in December. Yields fall as prices rise.

About $28 billion flowed into municipal-bond mutual funds and exchange-traded funds from January through September, according to the Investment Company Institute.

These investors are largely shrugging off two potentially disruptive events: multiple ratings downgrades in Hartford, Conn., where the mayor in July hired restructuring advisers; and what amounts to the largest-ever municipal bankruptcy, in Puerto Rico.

"Munis had a pretty good year," said J.R. Rieger, managing director of fixed-income index product management at S&P Dow Jones Indices LLC. "That's kind of a surprise to me given all the headline headwinds that the muni market is facing."

Increasing demand also came from foreign buyers. More than $3 billion flowed into municipal bonds from outside the U.S. in the second quarter, bringing the total amount of munis held by foreign investors to a record $98.6 billion, according to Federal Reserve data. With global interest rates still low, munis appeal to foreign institutional investors seeking safe long-dated securities, even though they don't benefit from federal and state tax exemptions.

Despite high demand in both the U.S. and abroad, munis are in fairly short supply. Municipalities this year have issued $276 billion in new bonds as of last week, down 18% from this time last year, according to Thomson Reuters. The state of Massachusetts has sold about $1.7 billion in general-obligation bonds this year, half the amount it had issued by this time last year, according to Municipal Securities Rulemaking Board data.

The drop-off comes as cities and states are doing far fewer refinancing deals this year; many governments typically refinance before a new presidential administration, to head off potential uncertainty, said Matt Fabian, a partner at Municipal Market Analytics.

One of the few hiccups to the rebound in prices this year was in September. Since last month, bond prices have fallen slightly alongside Treasurys after the Federal Reserve signaled it remained on course to steadily raise interest rates.

But that dip barely dented the upward trend in muni prices since January. Some bondholders were relieved after a Trump infrastructure plan that could have diverted the assets of large infrastructure investors away from muni bonds didn't materialize. Given that failure, the inability to repeal the Affordable Care Act and other setbacks for the Trump administration, investors became increasingly confident big changes weren't coming from Washington this year.

"As the year has worn on, there has been this understanding that these things, if they happen, they're not going to happen any time soon, and they may not happen at all," said Gary Gildersleeve, partner and portfolio manager at Evercore Wealth Management.

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