
Municipal Bonds Are Scarce. That's Good News for Borrowers.

U.S. states and cities are issuing fewer bonds, partly in response to changes to tax exemptions on refinancings.

The prices for municipal bonds have recovered from their worst first-quarter slump of the last 15 years. The reason: U.S. states and cities continue to cut back on their borrowing.

Municipalities borrowed $156 billion in the first two quarters of this year, down 17% from last year. Citigroup researchers are projecting that year-over-year decline will reach 25% by the end of the year.

The low supply is pushing up the value of existing bonds and reducing borrowing costs for some governments, particularly on riskier bond deals. Twelve-year bonds backed by settlement payments from tobacco companies to the state of California sold with yields of 3.07% in June, compared with yields of 3.25% in March of last year.

"It's a seller's market," said Howard Cure, director of municipal-bond research at Evercore Wealth Management, which invests in public debt. "We're trying to be careful about that aspect of it and not go down that path of sacrificing for a little extra yield and having a big decline in credit quality."

The Bloomberg Barclays Municipal Bond Total Return Index edged up 0.87% in the second quarter, after falling by 1.11% in the first quarter. The first-quarter drop was the biggest decline of any first quarter in the past 15 years.

About half of the drop in supply resulted from Congress's decision last year to end tax exemption for early refinancings of outstanding municipal bonds, according to an estimate by Vikram Rai, head of municipal strategy at Citigroup. Borrowers also rushed to sell municipal bonds amid talk of other legislative proposals—such as a ban on tax-exempt issuance by hospitals and universities—that weren't ultimately enacted.

"The rush to market toward the end of 2017 emptied out a lot of the forward pipeline," Mr. Rai said.

Aftershocks from the 2008 recession are also contributing to the drop-off. Municipal bonds typically become eligible for refinancing a decade after they are issued. Issuance of new money bonds fell 24% in 2008 as the recession destabilized city and state finances, leading to a smaller-than-usual crop of bonds eligible for refinancing in 2018.

Those factors combined to push the total amount of refinancing deals in the first half of this year down to $44 billion, the lowest since 2000.

All that scarcity has driven up prices despite rising interest rates, which typically erode the value of outstanding bonds. Central-bank officials last month raised the benchmark federal-funds rate by a quarter-percentage point, their second rate rise this year. They projected a total of four increases for

2018, up from three at their March meeting.

Exchange-traded funds are one relatively new beneficiary of the stronger demand for municipal bonds. Their municipal-debt holdings have grown from zero in 2007 to about $30 billion this year, according to federal data. The iShares National Muni Bond ETF received inflows of $630 million last month, the highest since December 2016, according to FactSet. The inflows followed a decision on June 1 to cut fees for that ETF by more than 70%.

Demand is expected to remain high in July and August, as outstanding bonds mature and investors look for new municipal debt investments, analysts said.

Some government borrowers could get an additional market boost from a recent Supreme Court decision banning public-employee contracts that require workers to pay union dues. The decision is expected to empower governments seeking to curtail pension benefits.

“You’re talking about the states retaining some negotiating leverage and being able to improve their fixed cost structure long-term,” said John Miller, co-head of Global Fixed Income at Nuveen Asset Management.

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