Investors Want Municipal Bonds, but Issuance Is Rare.

The 2017 tax overhaul and economic strength filling government coffers discourage offerings

Municipal bonds are rallying, spurred by a broad surge in demand for global debt and a lingering decline in borrowing by state and local governments.

Investors have poured a net $47 billion into municipal bond funds during the first six months of 2019, a record for the first two quarters, according to Lipper data from Refinitiv. The bonds have provided positive returns, including price changes and interest, on the Bloomberg Barclays Municipal Bond Index every month since November 2018, the longest streak since the summer of 2016.

The surge in investor demand has met a decline in debt sales by states and municipalities. The drop was spurred by provisions of the 2017 tax overhaul that limited alternatives for refinancing, some state budget officers said. At the same time, recent economic strength has filled the coffers of state and local governments, reducing their need to borrow and decreasing the already-low risk of defaults.

"There are not many munis around," said Guy Davidson, the chief investment officer of AllianceBernstein LP's municipal business. And strong balance sheets mean "the downside is pretty limited at the moment."

Municipal bonds, which fund civic projects ranging from tunnels to school renovations, are considered almost as safe as U.S. Treasurys because they are backed by tax revenue or payments from such essential services as water. They are largely owned by ordinary investors and have long served as a key component of retirees' savings because their interest payments are typically tax-exempt.

The surge in demand further eases worries that the 2017 tax overhaul would hurt municipal bonds by reducing the appeal of those tax-free payments. Many also expected the tax cuts to boost growth and inflation. Investors tend to sell the bonds when they expect robust growth, while inflation erodes the purchasing power of the debt's fixed payments.

The yield on the benchmark 10-year Treasury note, which rises as bond prices fall, hit 3.23% in November. But diminishing growth expectations and signs the Federal Reserve will shift to cutting rates have spurred a bond rally this year, driving the 10-year note yield below 2%. The yield on the Bloomberg Barclays Municipal Bond Index, an indication of how much it would cost governments to issue new debt, stood earlier this week at 1.95%, its lowest level since October 2016, and down from a recent peak of 3.08% in November.

"It's really just amazing how aggressive this market is," said Matt Fabian, a partner at Municipal Market Analytics. "They want tax-exempt income, and you can't get that anywhere else except for the muni market."

The drop in yields has been a boon to state and local governments. Florida's board of education last week sold a Aaa-rated 10-year bond at a yield of 1.64%.

Issuance in general has remained low. Municipal bond issuance slipped about 25% in 2018 and has stayed at modest levels in 2019, according to data from the Securities Industry and Financial Markets Association, an industry trade group.

Ben Watkins, director of Florida's division of bond finance, said a provision in the tax overhaul limited alternatives for refinancing muni bonds by issuing new debt and that "the only way we would take advantage of favorable markets and interest rates has been handcuffed by Congress."

That is likely to keep supply low, even as financial stability has improved at city and state governments. There were only 40 defaults in 2018, the lowest on record in Municipal Market Analytics data going back a decade. Mr. Fabian estimated that the total was probably a "multidecade low."

If municipal finances and demand for the debt remains strong, low supply could make yields fall even further, according to some analysts. Still, Mr. Davidson said the municipal bond market includes numerous everyday investors whose sentiment can "turn on a dime."

"Demand is not always a given," said Mr. Davidson. "Mom and Pop are easy to scare."

The Wall Street Journal

By Britton O'Daly

July 18, 2019