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Municipal Defaulters Decline Amid Improving Economy: Muni Credit.

Municipal issuers are defaulting at the slowest pace since at least 2010 as a strengthening economy boosts local-government finances.

With the U.S. economy expanding the most in more than a decade, improved balance sheets for cities and counties are easing concerns of widespread failures and supporting an unprecedented rally in their debt.

Fifty-seven issuers defaulted for the first time this year as of Dec. 30, compared with 69 in 2013 and 140 in 2010, according to Municipal Market Advisors, a Concord, Massachusetts-based research firm. The number will probably remain in a similar range in 2015 as cost-cutting municipalities in the $3.6 trillion municipal market have proven resilient, said Chad Farrington, head of muni research in Boston at Columbia Management Investment Advisers.

“For the vast majority of the credits, even a slow recovery is good enough,” said Farrington, whose company oversees about $30 billion in local debt. “It’s impressive how well they weathered the downturn. We’re not seeing major cracks on the horizon.”

Outliers include Detroit, which emerged from a record $18 billion bankruptcy this year, and Puerto Rico, whose electric utility is expected to restructure its debt, Farrington said. Most defaults are occurring in bonds issued for projects sensitive to the housing bust and recession, such as land deals and retirement homes, he said.

Hitting Bottom

The municipal market may be nearing a “baseline level of defaults” as issuers skip payments thanks to intrinsically flawed projects rather than the economy, said Matt Fabian, a managing director at Municipal Market Advisors.

The U.S. gross domestic product grew at a 5 percent annual rate from July through September, the biggest advance since the third quarter of 2003, according to revised figures from the Commerce Department released Dec. 23.

Banking analyst Meredith Whitney’s prediction in December 2010 of “hundreds of billions of dollars” of municipal failures created angst in the market that has dissipated, said Neil Klein, a senior managing director and principal at Carret Asset Management LLC in New York.

Breathing Out

“In 2013, we were still worried about what Meredith Whitney said. In 2014, it started to fall back to the wayside,” said Klein, who helps manage about $750 million of local securities. “Municipalities are standing on their own and trying to do the best they can, fiscally speaking.”

Detroit filed its bankruptcy in July 2013. Investors pulled a record $63 billion from muni mutual funds that year.

Since Detroit, no city, town, village or county has filed for protection, said James Spiotto, a bankruptcy specialist and managing director at Chicago's Chapman Strategic Advisors LLC, which advises on financial restructuring.

This year, individuals have poured about $21 billion back into muni mutual funds, Lipper US Fund Flows data show. With the influx came an unprecedented rally, with munis posting gains each month for the first time since at least 1989, according to Bank of America Merrill Lynch data. The year's 9.7 percent return is the most since 2011.

Choosing Wisely

Municipal issuers also took advantage of rates close to generational lows to refinance and improve their balance sheets, Klein said. They slowed borrowing for capital expenses except for "only the most important projects," Klein said. As a result, the U.S. municipal-bond market shrank by $30.3 billion during the third quarter, cutting debt to the least in five years, according to the Federal Reserve Board.

While the U.S. economy has improved, municipalities still must adjust costs to account for lower revenue, Janney Capital Markets said in a Dec. 16 report.

The analysts recommended that investors pick "high quality municipal issuers that understand the new financial reality and have made or are making budget adjustments."

Tax receipts collected by state and local governments as a percentage of gross domestic product won't return to the high reached in 2007 until 2058, projected the U.S. Government Accountability Office.

Localities "would need to make substantial policy changes to avoid fiscal imbalances," said the office's Dec. 17 report.

Pathetic Debt

Most issuers skipping debt payments for the first time this year weren't governments, but agencies and districts. They were "tiny, unrated, and unloved" credits, Fabian said.

About 82 percent of the defaulters carried no ratings at the time of sale, he said.

Summit Park District, which runs recreational facilities for a village near Chicago and receives funding through property taxes, fees and grants, defaulted on $2.1 million of unrated general-obligation debt certificates due Dec. 1.

It fell short of principal and interest payments because "due to construction and project delays, the grants were not received in full," the district said in a Dec. 11 posting on the Municipal Securities Rulemaking Board's website.

Ross Bruni, the district's executive director, said in an e-mail that additional debt was issued to pay the balance, about $541,000, according to the notice. A state payment will retire that, he said.

About 20,000 municipal credits carry grades by the ratings companies, and only about 40 are listed as defaulted in the MMA database, Fabian said.

“The data implies that as an investor, if you are only worried about default risk, you can buy anything rated,” he said.

(An earlier version of this story didn’t include that the GAO projection of tax receipts was as a percentage of gross domestic product.)

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