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Buying Cigarettes With Gas Money Keeps Tobacco-Bond Rally Aflame.

Lower-for-longer oil prices might mean higher-for-longer prices on municipal tobacco bonds.

Tobacco securities, which are repaid from legal-settlement money that states and localities receive from cigarette companies, have been a top-performer over the past two years. That's because — for the first time in a decade — Americans aren't giving up smoking. Instead, as gasoline costs plummet to the lowest level since 2009 along with oil prices, they're spending their savings on cigarettes. And the more the companies sell, the more governments get.

High-yield tobacco debt has gained 2.8 percent in 2016, compared with 1.5 percent for all speculative-grade obligations and 1.1 percent for munis as a whole, Barclays Plc data show. Some securities are at the highest prices since 2013 after the segment of the market posted double-digit returns in each of the last two years.

"One of the benefits of low energy prices is when people go and buy their cigarettes, instead of getting the no-frills brand, they can actually buy the major manufacturers, which is good for our tobacco bonds," said Jim Schwartz, the head municipal credit analyst at BlackRock Inc., which oversees \$110 billion of state and local debt.

Across the U.S. tobacco industry, cigarette shipment volumes were little changed in 2015 compared with a year earlier, according to regulatory filings from Reynolds American Inc. The company, along with Lorillard Inc. and Philip Morris USA, agreed in a 1998 settlement to make annual payments to states in perpetuity to settle liabilities for health-care costs tied to smoking.

Reynolds, the maker of Camel and Pall Mall cigarettes, shook up the tobacco industry last year when it paid \$25 billion to acquire Lorillard, whose biggest product is the Newport menthol line. With the new brand, Reynolds's shipment volume grew 17 percent year-over-year. In a conference call, Debra Crew, president of R.J. Reynolds Tobacco, cited lower gasoline prices as a reason for higher sales.

The resilience of cigarette purchases is a departure from the trend over the past decade, when tobacco companies saw demand decline in the face of anti-smoking campaigns, higher taxes and the growth of e-cigarettes. From 2007 to 2014, shipments fell an average of 4.7 percent annually, according to the National Association of Attorneys General. The 0.1 percent decline last year was the least since 2006.

Tobacco debt has rarely had a bad day in 2016, gaining in 32 of 41 trading sessions, according to data from S&P Dow Jones Indices.

"The market is catching up to how large of an impact near-term consumption declines can have to long-term bond valuations," said David Hammer, who oversees about \$40 billion as co-head of the muni portfolio team at Pacific Investment Management Co.

The largest single tobacco bond, a Ohio obligation with a June 2047 maturity, climbed to an average

90.4 cents on the dollar on March 1, the highest since May 2013, data compiled by Bloomberg show. That's equivalent to a 6.6 percent tax-free yield. The debt is rated six steps below investment grade by Moody's Investors Service and Standard & Poor's.

Most tobacco securities are considered junk because when governments first sold them more than a decade ago to get advances on their legal settlements, they didn't anticipate how quickly Americans would give up smoking. Moody's projects that a 4 percent annual decline in cigarette shipments would cause 80 percent of the bonds to default.

"We continue to use a more severe consumption decline scenario than what we've experienced historically as our base case," said Hammer, whose high-yield municipal fund has outperformed 99 percent of peers in the past year. The top three holdings are tobacco securities. "But we have acknowledged the recent trend that consumption declines have slowed, which makes a big difference on tobacco bonds as a whole."

The bonds are different than most in the \$3.7 trillion municipal market because they'll continue to pay in perpetuity, even if there's not enough money to make full payments and they default. Tobacco securities are also among the most frequently traded because sometimes taxable buyers will step in and purchase the obligations if they get too cheap.

That probably hasn't been the case lately, because the taxable high-yield market has been dragged down by energy companies, making corporate debt cheap relative to municipal tobacco bonds.

"If you're a corporate high-yield buyer, it's the most expensive you've seen them since the financial crisis," said Guy Davidson, director of municipal fixed-income in New York at AllianceBernstein Holding LP, which oversees about \$32 billion of state and local debt. "I'd bet most of the buyers in the last year have been muni buyers and the sellers have been largely taxable ones."

With Puerto Rico tied up in a restructuring battle, speculative-grade muni investors have few alternatives to buy, meaning tobacco bonds could continue to climb, Davidson said. He helps run a \$2.3 billion high-yield fund that has four of its five largest holdings in tobacco. It beat 95 percent of peers in the past year.

Individuals have poured money into high-yield municipal funds for 21 straight weeks, adding \$4.2 billion over the period, Lipper US Fund Flows data show.

It also helps that gasoline remains below \$2 a gallon and the national unemployment rate is the lowest since February 2008. Neither metric shows signs of changing soon.

"People have more money in their pockets and they seem to be buying cigarettes," Davidson said. "We think tobacco bonds are still attractive. We wouldn't underweight them, even though they've had a good run."

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