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Funds From Japan to Europe Pivot to Munis as Credit Appeal Wanes.

If you're a pension fund or insurer from Europe or Japan, U.S. investment-grade credit may be getting a little passe.

That's the view of Principal Global Investors, which sees taxable municipal notes becoming a more popular alternative for some overseas-based institutional investors as they chase additional yield in a world of record-low central bank interest rates. Tax-free munis typically have little appeal for overseas buyers, who may not benefit from the securities' exemption, although local government notes with taxed payouts do draw buyers from abroad.

"From a non-U.S. investor standpoint, taxable munis have the same yield as you get from U.S. investment-grade credit," said Mark Cernicky, who oversees about \$100 billion at Principal in London. "It's higher credit quality, they have much lower default rates, and it's also a play in infrastructure."

The average yield on taxable munis due in 5-to-10 years is 3 percent and the rate on similar tenor U.S. corporate notes is 2.95 percent, Bank of America Merrill Lynch indexes indicate. While data compiled by Bloomberg show issuance of investment-grade corporate bonds in the U.S. has already topped \$1.17 billion this year and is running at a record pace, Cernicky said the advanced age of the current credit cycle will spur investors to pivot more toward taxable munis.

The increasing prevalence of behavior that's more friendly to shareholders than creditors — such as acquisitions — may also encourage that shift, as could the prospect that the European Central Bank will eventually dial back stimulus measures that have supported the corporate bond market, he said in an interview in Sydney on Thursday.

"You're going to continue to see that diversification trend in taxable munis," Cernicky said. Local governments sell taxable bonds when the issues don't meet Internal Revenue Service standards for tax-exemption, such as for pension funding because the money is invested to make a profit, or if a certain amount of proceeds goes toward commercial use.

Pension funds and other institutional buyers are also looking to do more private lending to companies as a way of diversifying the riskier part of their portfolios away from speculative-grade bonds, Cernicky said. There's been a "significant increase" in requests for such arrangements among Japanese and European clients, he said.

"They're reducing high-yield exposures and going into private credit, illiquid credit or private lending," he said. "You get a similar type of return, but you get no mark-to-market volatility."

The shift has come amid a reduction in junk bond sales this year, with new issuance in the U.S. 19 percent less than at the same point in 2015, according to data compiled by Bloomberg. Cernicky is tipping that to turn around next year, with energy, metals and mining companies leading the charge in the world's biggest non-investment-grade note market. He also expects more industrial companies

to make their debut in the European junk bond market next year.

“The story in 2017 is likely going to be about high-yield issuance, not so much the IG issuance,” he said. “In Europe, you see a lot of new companies coming into the market which is actually pretty positive.”

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by Ruth Liew

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