Bond Case Briefs

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The Outlook For Municipal Bonds.

The next decades will bring a level of municipal bond defaults unlike anything seen since the 1930s. Those who are interested in preserving their wealth or retirement prospects should give serious consideration to holding insured bonds.

Municipal bonds have become more attractive than ever after the recent tax reform, which left people with high income and wealth even fewer options for preserving what they already have. Given the meager returns offered by the taxable bond market, one might even wonder why municipal yields aren't lower than they are. But before you pile further into this market, let's look at the long-term outlook. It isn't all that rosy.

Government at all levels has been splurging on debt for decades with the last ten years being among the worst. This because 2008 shook investor confidence in anything without a solid guaranty behind it, and what is more solid than government that can't go out of business. Our federal government was the worst offender, doubling the national debt to $20 trillion in just eight years. They can do this and more because they tax income and can print money. State and municipal governments are not as fortunate since they tax mainly wealth through property taxes. Their ability to tax income is limited and results in a loss of population, at least of population with income and assets.

A short reminder on the nature of debt. It is a way of robbing future revenues to satisfy current priorities and needs. When this borrowing from the future is in order to maintain the general public's well being and grow the economy, it is a positive economically and improves the quality of life for the tax payers burdened with servicing that debt. Bonds for such purposes as public works, infrastructure and housing come quickly to mind as having such positive effects. Bonds issued for budget shortfalls, pension plans, social programs and non-governmental facilities, not so much.

Today, government at all levels face a crisis that will play itself out over the next decade. This crisis is due to trillions of dollars of unfunded mandates for pension and health care obligations as the baby boomer generation retires and draws on government funds rather than being contributors. That's right, government has not only robbed the future through excessive borrowings, it has also failed to fund its promises to public workers and citizens. Promises that were gambled away, future cash flow for debt service that produced little meaningful benefit. The crisis that is coming is when government, facing a cash crunch, has to sit down with its workers, retirees and bondholders and ask them to share the pain. While bondholders may feel that the promises to them are legal and binding, be sure the other parties feel the same way and they have the media and public opinion on their side. Be assured, bondholders will suffer the most.

We have precedent for the outcome we can expect for bondholders: Going back to the 1980s when the Washington Public Power and Supply System defaulted on $2.25 billion in bonds. The Washington Supreme Court ruled the authority had to pay because of the wording of the state fraud statutes. However, media attention demonized bondholders as robber barons and the state legislature retroactively changed the fraud statutes to hold governmental entities to a less severe fraud standard.

We see in the current Puerto Rico debacle–where the stakes are much higher–more than $73 billion for bondholders and $40 billion or more of unfunded pension obligations. The hurricane damage there has given impetus to U.S. Senator Elizabeth Warren calling for a total debt forgiveness.

What is likely to happen over the next few years is governments at all levels issuing bonds for unfunded mandates. In realty, such bond issues solve nothing economically. However, issuing such bonds means that when the financing crisis hits, i.e. when there is not enough cash to meet current expenses, there will be more people sitting at the table to share the pain. If the past is any indication, bondholders will not be holding the strongest hand, it will be current employees and pensioners.

Many bondholders may think their best option is to invest in munis via a mutual fund. The thinking is that such funds have the expertise in bond selection and offer greater diversification of risk. But their strategic priority is always to attract the next investor dollar, not to retain what they already have, so risk is generally rising to keep overall returns competitive.

Apparently bondholders are catching on since there has been a net exodus from such funds over the last two years. This is not surprising since it was these mutual funds that bought many of the Puerto Rico along with Florida Community Development Districts, pension plan funding and tobacco bonds.

The better solution is for bondholders to buy only bonds insured by a mono-line bond insurer. These are companies that insure both the principal and interest payments on a bond issue. Their advantage over the expertise of bond funds and credit rating agencies is that when they are wrong, they, not you, suffer the loss. This is why some of the Puerto Rico bonds today still trade at par.

While Puerto Rico is the focus of default today, in fact there are currently more than 70 bond issuers totaling $1.3 billion that are being serviced by a guarantor. Historically, since 1980 more than 300 bond defaults of insured bonds totaling $4.6 billion have been settled at full value. Most of the bond insurers have disappeared since 2008 because they strayed into insuring corporate bonds and derivatives. But even then, they were absorbed by the surviving insurers who assumed the outstanding contracts. While insured bonds may provide a fractionally smaller yield than the equivalent issue that relies exclusively on the promise of government, long-time observers know that we live in a different time politically and that in most things today, politics trump promises (no pun intended).

Forbes

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Jan 24, 2018

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