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Investors Speculate on Return of Crisis-Era Build America Infrastructure Bonds Under Split Congress.

This infrastructure-bond structure, backed by federal subsidies, could face uphill battle in Congress

With Democrats sweeping into the House in the midterm elections, analysts are touting the potential comeback of crisis-era municipal bonds as part of a broader infrastructure bill.

Talk of major infrastructure legislation has gained ground as investors marked it out as the rare area where Democrats and President Donald Trump shared common ground. That has drawn speculation of the potential re-introduction of Build America Bonds, taxable municipal bonds issued by local governments to finance infrastructure projects, that came to life in 2009 when former President Obama launched a wave of fiscal stimulus measures to revive a recession-hit economy.

"It may be brought back in some form," said John Mousseau, director of fixed income at Cumberland Advisors.

The need for infrastructure spending has been felt on both sides of the aisle. The American Society of Civil Engineers estimated the total cost of leaving the U.S.'s potholed roads, aging airports and rusting bridges in disrepair amounted to more than $4 trillion by 2025. They estimated the gap needed to keep U.S. existing infrastructure in adequate shape at $1.4 trillion.

In Trump's earlier plans, he proposed the federal government would chip in with more than $200 billion through tax incentives and grants. This would serve as seed money to attract another $1.3 trillion from businesses and local municipalities, the administration had proposed.

"We have a lot of things in common on infrastructure," Trump said of the two political parties at a White House news conference after the midterm election results.

BABs have been touted as one solution to shoring up America's ailing infrastructure in part because of a strong track record in a period when local governments struggled to gain access to bond markets.

The U.S. Treasury sold more than $180 billion of BABs in their short existence before they were phased out in 2010. Some of the bonds still remain in investors' portfolios, including in the Nuveen Build America Bond Fund NBB, +0.16% and in the Taxable Municipal Bond Trust BBN, +0.20% .

Backed by federal subsidies that lower costs for the local issuers, BABs were able to offer richer yields, a feature designed to compensate for their lack of tax-exempt status but also to make them competitive against higher-yielding corporate bonds. BABs attracted a pool of non-traditional buyers including pensions funds and foreign investors, who were unable to take advantage of the tax-exempt income from municipal bonds.

But talk of federal subsidies means a municipal bond issue constructed similarly to BABs would likely face an uphill battle in Congress, even when Trump voiced support for infrastructure spending throughout his presidency.

“Resistance to the required spending, in the form of annual interest subsidies, is likely, especially as the growing budget deficit is poised to become a contentious issue in the new Congress,” said Alan Schankel, municipal strategist at Janney Montgomery Scott.

After the tax cuts, fiscal conservatives in the Republican-controlled Senate may be unwilling to support another deficit-widening stimulus measure. The budget deficit is on record to widen to a trillion dollars by 2020, according to the Congressional Budget Office. Treasury bond issuance is set to rise to a more lofty $1.34 trillion this year.

And analysts say it’s not clear if Congress needs to bring BABs out of retirement when the tools at hand may be sufficient.

With municipal issuance muted relative to last year, the demand for tax-exempt yield has largely ensured the success of infrastructure bond deals, meaning there are buyers in abundance and projects are getting funded. According to the Securities Industry and Financial Markets Association, municipal bond issuance is down 14% year-to-date from 2017.

Mousseau pointed to the strong demand for recent multibillion dollar bond sales funding a new terminal in New York’s LaGuardia airport and a replacement for the Tappan Zee bridge, both of which relied on a mix of taxable and tax-exempt municipal debt.

“Big deals have had no problem selling bonds,” said Mousseau.

Market Watch

by Sunny Oh

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