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A Boon to $85 Billion Muni Tobacco-Bond Market Seen From FDA.

- **Citigroup says newly approved device could stanch sales drop**
- **'This is going to cannibalize Juul,' says analyst Rai**

One of the most volatile corners of the municipal-bond market is being whipsawed by Washington.

Securities backed by the payments states receive from the 1998 legal settlement with tobacco companies tumbled at the end of April after legislation was introduced in Congress to raise the age for buying cigarettes, a step that threatened to accelerate the steeper-than-anticipated drop in consumption that's weighed on the prices of the bonds.

But there may be a reversal-of-fortune for the $85 billion sector, thanks to the federal government. The U.S. Food and Drug Administration's April 30 approval of a tobacco-heating device could win back consumers that have switched to e-cigarettes, like Juul, and help stanch the decline in annual settlement payouts that finance the securities, according to Citigroup Inc. analysts led by Vikram Rai.

The Philip Morris International device heats a stick of tobacco in a way that produces a traditional cigarette taste without as many toxins. Citigroup's analysts anticipate that the sales from the device — unlike e-cigarettes such as Juul — will be included in the tally of annual cigarette shipments that determine the settlement payments.

"Juul is cannibalizing conventional cigarette sales," said Rai. "This is going to cannibalize Juul."

Tobacco bonds are a volatile part of the $3.8 trillion municipal market because they're heavily traded, making them easy for fund managers to sell whenever customers pull out their cash.

Regulatory decisions in Washington have also played a role in price swings. In November, junk-rated tobacco bonds dropped following reports the FDA was considering restricting menthol in cigarettes, and some of the riskiest securities plummeted 22 percent in 2010 after a 62-cents-a-pack federal tax increase dented sales.

Since states started selling bonds to get an advance on their settlement money, the traditional cigarette business has been in steady decline because of stricter regulation, tax increases and public health campaigns. E-cigarettes that deliver nicotine less harmfully have also cut into sales.

Altria Group Inc., the parent of Philip Morris USA, revised its estimate for the 2019 domestic cigarette industry volume to a decline of 4 to 5 percent, primarily because of increased gas prices and "other factors" it didn't specify.

Such declines helped push junk-rated tobacco bonds to a 0.6 percent decline in April, the sector's worst return since November. They were the only category of high-yield municipal bonds to suffer losses, according to the Bloomberg Barclays Muni High Yield Index. This month, they've pared that drop, returning 0.75 percent, compared with a 0.48 percent for the high-yield index.

Sales of HeatSticks, a heated tobacco unit used with the IQOS device, will contribute to the settlement agreement payments through Altria's Philip Morris USA, which is marketing both of the Philip Morris International products domestically. How much money that could add is hard to calculate, since Altria and the international unit haven't disclosed the terms of their licensing agreement.

The potential success of the device may hinge on the the ability of Philip Morris to convince smokers that the e-vapor system are less risky than cigarettes but more satisfying than rival products, according to Bloomberg Intelligence analysts Kenneth Shea and Gopal Srinivasan. And it will need to comply with the same marketing restrictions imposed on traditional cigarettes, which include bans on television and radio advertising.

Citigroup expects tobacco bonds will perform well even before the product gains ground, in part because of a supply crunch that is affecting the broader municipal market. Those that\ were issued in the early to mid-2000s and have higher coupons and could produce 11 to 12 percent returns this year, Rai said.

"As long as the market doesn't go into a tailspin, as long as inflows continue, by virtue of the high coupon, the returns are pretty good," Rai said.

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