[Bond Case Briefs]

Municipal Finance Law Since 1971

[New York State Is Paying Up to Borrow With a Taxable Bond Sale.]

The state of New York will pay high interest rates on $914 million of bonds it sold this week—high compared with peers, at least.

The extra cost isn't the result of bad credit; the state has the second-best credit rating available from Moody's and S&P Ratings. The typical 10-year muni bond with a comparable rating yields around 1.6%, according to FMSbonds. But New York's 10-year bond yields 2.55%.

Investors demanded higher yields because they will pay federal tax on the bonds' interest income. That is fairly unusual in the municipal bond market, and even more so among "general obligation" bonds, the type of debt New York issued. In other words, most G.O. bonds pay interest that is exempt from federal income tax. For example, the state of Minnesota sold tax-exempt 10-year G.O. bonds at a yield of 1.38% in August.

New York's bonds are taxable because of the way the state plans to use the proceeds from the sale. The state will use that $914 million to refinance outstanding bonds that mature between four months and 22 years from now. Such transactions are called "advance refundings."

Until 2018, investors could earn tax-exempt income from bonds sold in advance refundings. But a provision in the 2017 Tax Cuts and Jobs Act removed that exemption. That ostensibly killed the market for advance refunding bonds, and meant that municipalities had to find new projects to finance if they wanted the tax exemption.

But then came this year's rally in the Treasury market, which pushed yields lower and reduced interest costs for all types of borrowers, including municipalities. That prompted municipalities to do advance refundings, anyway, and sacrifice the tax exemption altogether. Issuers have sold $50 billion of taxable muni bonds so far this year, according to Citigroup , the highest volume since a flood of Build America Bonds, also taxable, hit the market in 2010.

Advance refundings are a notable share of the supply of new taxable bonds, said Matt Fabian, partner at Municipal Market Analytics. The spread between yields on taxable and tax-exempt munis has narrowed as well, he said.

Part of the reason for the demand is that taxable munis could provide better value than corporate bonds, which are also taxable. The broader muni market has been trading at expensive valuations of late.

Corporate bonds provide less yield compared to Treasuries than they did at the start of the year, while taxable munis' yield spread has remained mostly steady, according to Citigroup strategist Vikram Rai.

"This is good news for prospective crossover buyers, because this under-performance has led to a moment of cheapness," Rai wrote in a Oct. 28 note.

Barron's

By Alexandra Scaggs

Oct. 30, 2019 12:54 pm ET