

# **Bond Case Briefs**

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## **WSJ: Detroit's Woes Add to Angst Over Municipal Debt.**

Municipal-bond prices have fallen further than other debt amid rising U.S. interest rates this summer, highlighting investor jitters spurred by Detroit's record-setting bankruptcy filing.

Bonds from some financially troubled issuers, like Puerto Rico and Chicago, have been particularly hard hit. Debt from the Windy City, which was downgraded by Moody's Investors Service last month amid questions about its pension liabilities, now yield about 1.50 percentage points more than a municipal market benchmark, up from about one percentage point in early July, according to Dan Toboja, senior vice president in fixed-income trading at investment bank and broker-dealer B.C. Ziegler & Co. in Chicago. Higher yields indicate lower prices.

"Credit concerns are front and center in this market," Mr. Toboja said.

The Motor City's case has been particularly worrisome for municipal-bond investors because the city's emergency manager has indicated that bondholders could see significant losses, undermining investors' assumption that states and cities would raise taxes as much is necessary to repay them.

Yields on investment-grade municipal bonds have risen to almost the same as similarly rated corporate bonds. That is a rare occurrence, considering municipal bonds have lower default rates and the interest is generally tax free. As of Tuesday, yields on corporate bonds were 3.37% and yields on municipal bonds were 3.33%, according to investment-grade indexes from Barclays. Typically, municipal bonds yield about 25% less than corporate bonds.

Debt prices in general have weakened since May. The Federal Reserve has discussed slowing its easy-money policies as the economy improves, prompting long-term bond yields to increase. The Fed has been buying \$85 billion a month in Treasury notes and mortgage bonds to stimulate the economy by keeping rates low but could start reducing those asset purchases soon, which could push interest rates higher.

The municipal-market selloff has been steeper, though, thanks in part to Detroit's bankruptcy filing on July 18, which listed more than \$18 billion in obligations and is the largest municipal bankruptcy filing ever. When rates rise, prices on existing bonds fall.

A few Michigan municipalities have decided to postpone bond sales, because investors spooked by Detroit's filing have demanded interest rates that were too high.

Detroit's bankruptcy filing came at a bad time for the municipal market. Investors already had begun pulling money out of municipal-bond mutual funds due to general interest-rate fears, and large outflows have continued after the filing. Over the past 13 weeks, municipal-bond mutual funds that report weekly have seen a net outflow of \$20.7 billion, while investment-grade corporate funds have seen a net inflow of nearly \$7 billion, according to data provider Lipper.

Municipal-fund outflows "tend to pick up momentum when you have negative headlines like Detroit," said Tom Weyl, director of municipal strategy at Barclays. "Certainly, Detroit has added to what was

happening already.”

The last time municipal bonds yielded almost as much as corporate debt was in mid-2011, after analyst Meredith Whitney predicted hundreds of billions of dollars of municipal-bond defaults. The prediction didn’t come true.

Some investors said they are taking advantage of the opportunity to buy municipal debt on the cheap, in part because they believe it remains safe. Specifically, some investors are focusing on municipal bonds issued by public entities but backed by corporations, because those bonds are yielding more than pure corporate bonds issued by the same companies.

For instance, an International Paper Co.-backed, tax-free municipal bond that matures in 2019 traded at a yield of 4.48% on July 24. That compares with a taxable yield of 3.23% on a similarly rated International Paper corporate bond on July 29. The proceeds from the International Paper municipal bond refinanced existing debt that paid for various environmental projects, like improvements to a landfill and pollution control at a paper mill.

Detroit has been worrisome for municipal-bond investors because the city’s emergency manager has indicated that bondholders could see significant losses, undermining investors’ assumption that states and cities would raise taxes as much is necessary to repay them. A vacant house sits in a once-thriving neighborhood in eyeshot of Detroit’s central business district. The General Motors headquarters is in the background.

“The fact that tax-free is higher than taxable and the issuer and credit guarantor are the same is absurd and signifies an inefficient market,” said David Kotok, chairman and chief investment officer of Cumberland Advisors. He said tax-free debt backed by Marathon Oil Corp. also was trading with a higher yield than the equivalent corporate bond.

Others, though, are keeping their powder dry. Bill Larkin, fixed-income portfolio manager at Cabot Money Management, said he still is worried that interest rates will rise and said he is sitting on the most cash in his 19-year career.

Although bonds are yielding more now than they were a few months ago, and municipal debt is relatively cheap, rates are still at fairly low levels historically.

“When the tide goes out, there are better places at the beach, but when it comes in, you’ll be underwater,” said Mr. Larkin, who helps oversee \$500 million.

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