Cities Fixing Budgets Prove Haven Amid U.S. Impasse.

Municipal bonds are rallying the most in six months against federal debt, showing how bolstered local-government budgets are making city and state borrowings a haven from political turmoil over a possible U.S. default.

While interest rates on 12-month Treasuries have almost doubled since the U.S. shutdown began Oct. 1, yields on AAA munis maturing in a year have dropped. The ratio of the yields, a measure of relative value, fell to about 208 percent yesterday from 370 percent Sept. 30, data compiled by Bloomberg show. The narrowest gap since April indicates that state and city bonds have grown more expensive.

The shift shows investors are betting that improving state and local tax revenue will cushion munis should U.S. lawmakers fail to break an impasse over raising the $16.7 trillion debt ceiling. The federal government will run out of room to borrow more on Oct. 17, according to Treasury Secretary Jacob J. Lew.

“You have a safe haven in municipal bonds because of the diversification of issuers and the strength of repayment capacity on the state and local level,” said Benjamin Thompson, chief executive officer in New York at Samson Capital Advisors, which oversees about $6 billion in local debt.

“There’s stability and predictability to this market that you’re not going to see in the Treasury market, which is going to come down to a few key political decisions made at the top echelon of government,” he said.

Healthy Cities

Unlike at the federal level, budget battles have receded in statehouses, where tax collections have increased for 15 straight quarters, Census Bureau data show. During fiscal 2013, which ended in June for most states, revenue rose 5.3 percent from the prior year, boosting the amount of money they had at year-end by 23 percent, according to the Denver-based National Conference of State Legislatures.

U.S. cities, which have taken longer to rebound from the 18-month recession that ended in June 2009, are also showing strengthened finances. They’re projecting their first revenue increase since 2006, according to a survey released last week from the Washington-based National League of Cities.

Benchmark one-year munis yielded 0.31 percent yesterday, down from 0.33 percent on Sept. 30, Bloomberg data show. The interest rate on 12-month Treasuries rose to 0.15 percent, up from about 0.09 percent on Sept. 30.

States’ Strength

State general-obligation bonds are considered sub-sovereign debt, backed by governments’ full faith and credit and taxing authority. The securities have rallied compared with the rest of munis, with yields 1.02 percentage point below the average for the $3.7 trillion market, Bank of America Merrill Lynch data show. That's the widest advantage since August 2011, when the federal government last had a debt-ceiling showdown.

Interest payments on most munis aren't directly tied to the federal government. Debt service is instead funded from sources such as state and local income taxes, water and electricity fees and hospital charges.

Moody's Investors Service said last month that local bonds backed by federal mass-transit aid, called Grant Anticipation Revenue Vehicles, or Garvees, are the most vulnerable to a U.S. shutdown. At least $10 billion of the bonds are outstanding, according to Bloomberg data.

'Feel Better'

Some Alabama Garvees maturing in September 2023 traded yesterday at a yield of 3.14 percent, or 0.57 percentage point above benchmark munis. It was the widest spread since Sept. 26.

"These sub-sovereigns — states, local governments and essential revenue issuers — may on a relative basis feel better to investors to be in than something with a more direct link to the U.S. government," said Jamie Iselin, head of munis at New York-based Neuberger Berman. The company oversees about $9 billion in local debt.

Local-government budgets are vulnerable should the federal stalemate continue. Forty states rely on federal revenue for at least 31 percent of total government funds, according to Moody's.

States such as Louisiana, Idaho and Arizona, which rely on federal dollars for at least 41 percent of total funds, may compensate by transferring less money to localities and health-care providers, Moody's said.

That process was one reason cities have struggled to raise revenue after the longest recession since the 1930s. The projected increase still won't be enough to keep pace with spending as pension and health-care costs increase, according to the League of Cities survey.

'Tenuous' Improvement

"Cities are starting to see improvement, but we know that it's tenuous," Christiana McFarland, one of the survey's authors, said in an interview. "Given the climate at the federal level, cities have reason to be cautious."

The standoff in Washington has failed to deter some municipal issuers. States and cities are set to offer $4.9 billion in bonds this week, the most since the period through Sept. 27.

By Brian Chappatta October 16, 2013