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CNBC: Is the Muni Bond Market About to Blow Up?

When there is turmoil in the $3.7 trillion municipal bond market, as there has been this year, America's mayors get very nervous. Scott Smith, mayor of Mesa, Ariz., and president of the United States Conference of Mayors, said, "The vast majority of infrastructure in this country is financed by tax-exempt financing; most of the schools, most of the streets, most of the sewer lines and the highways." According to the Conference of Mayors, between 2003 and 2012 90 percent of the munis issued (worth about $1.65 trillion) went to build infrastructure.

Normally that pipeline of money is pretty steady, but this year has not been normal. Drawing parallels to the 2008 financial crisis, the sell-off in June was the biggest in 20 years, amounting to about 2.2 percent of the $680.7 billion managed by municipal bond mutual funds.

Add to that Detroit's bankruptcy filing, the likelihood that Puerto Rico's debt may be downgraded to junk status, SEC accusations that the city of Miami misled bondholders about the city's financial condition, and a proposed overhaul to the U.S. tax code, which might include eliminating the federal tax exemption for muni interest, and you have confluent forces stirring up a volatile market.

Bond fund managers and strategists keep insisting that the great majority of issuers are in decent financial shape. They also say the problems in Detroit and Puerto Rico have been well known for years and should have no ripple effect on healthy bonds. Nonetheless, the fear that unfunded pensions and health-care liabilities are waiting like time bombs elsewhere has persisted.

Market volatility

Since March, according to Morningstar, about $50 billion has fled the market. As of September, the S&P Municipal Bond Index was down roughly 3 percent for the year. According to BlackRock, as of September new issuance for 2013 was down 13 percent from last year.

The immediate danger for Puerto Rican bonds—which are widely held by U.S. bond funds—is that ratings agencies may downgrade the territory's debt to below-investment grade status. According to Morningstar, about 180 mutual funds with $100 billion in combined assets had at least 5 percent of their portfolios in Puerto Rico bonds as of their latest disclosures.

That would cause cash strapped Puerto Rico's borrowing costs to skyrocket. During an early October conference call with investors, Governor Alejandro Garcia Padilla denied that the territory was near bankruptcy or would need a federal bailout. "We will do everything, and I repeat, everything that is necessary for Puerto Rico to honor all its commitments," he said. "It's not only a constitutional, but also a moral obligation."

If history is a guide, a bond downgrade could foreshadow the state's fiscal downfall. Detroit's debt was downgraded to junk in 2009. That was the prelude to city's bankruptcy filing this July. A federal judge is hearing arguments about whether the city is actually bankrupt now. Some of the city's largest creditors including its municipal worker's unions insist that it is not.

If the bankruptcy goes forward, a big question for the judge to settle will be who has first dibs on Detroit's assets: its bondholders or its retirees? Any eventual ruling on the subject could influence the potential bankruptcy plans of other troubled municipalities and spook muni bondholders.

"This is a big deal," said George Friedlander, chief municipal strategist with Citicorp Investment Research and Analysis. Mayor Smith of the Conference of Mayors added, "If all of the sudden a retiree's medical benefits are on an equal stage or even take precedence over bondholders, you can well imagine that would certainly have a chilling effect on the municipal market."

Interest costs with and without tax exemption

$ in mil

current law with 28% cap with full repeal

Estimated interest cost with tax exemption Estimated total interest cost cost increase Estimated total interest cost cost increase

2003 114,128.55 130,876.97 16,748.42 161,981.19 47,852.64

2004 96,239.27 110,820.97 14,581.71 137,901.29 41,662.02

2005 121,966.14 141,458.44 19,492.31 177,658.44 55,692.30

2006 118,248.09 137,017.62 18,769.54 171,875.34 53,627.25

2007 125,282.78 145,214.14 19,931.35 182,229.50 56,46.72

2008 140,294.09 161,012.63 20,718.54 199,489.91 59,195.82

2009 110,288.35 126,890.90 16,602.55 157,724.20 47,435.85

2010 91,207.92 105,952.85 14,744.93 133,336.29 42,128.37

2011 83,022.35 95,965.70 12,943.35 120,003.35 36,981.00

2012 100,111.45 118,949.63 18,838.18 153,934.81 53,823.36

TOTAL 173,370.87 495,345.33

Source: SIFMA estimates based on Thomson Reuters data

Bracing for a tax overhaul

Another worry looming over the entire municipal bond market is the possibility that munis might be stripped of their federal tax exemption. The exemption has been part of the tax code since 1913. The Obama administration has proposed eliminating, or reducing that exemption, as part of a planned rewrite of the tax code. Any final tax reform plan would somehow have to satisfy Democrats who are looking to raise revenues and Republicans who have declared they will not tolerate any tax increases.

That has focused attention on eliminating loopholes, deductions and exemptions, like the one on munis. Muni issuers have argued that tampering with the exemption would be ruinous for their efforts to fund needed infrastructure and have launched an intense lobbying campaign against it.

In February, the National Association of Counties, the National League of Cities, and the U.S. Conference of Mayors released a report claiming that had the tax exemption on munis been eliminated in 2003, issuers would have had to make an additional $495 billion in interest payments between then and 2012. This summer 137 members of Congress signed a letter opposing the idea of altering the exemption.

The fallout effect

The Conference of Mayor’s Mayor Smith says reducing or eliminating the tax exemption would dramatically increase borrowing costs for cities and make needed infrastructure building prohibitively expensive. “We think that tinkering with it brings some uncertainty that is just untenable for cities.” He adds: “Two things would happen: either we’d have to redirect money from other programs, or we’d have to build less.”

Tax writers—Democratic Sen. Max Baucus, chairman of the Senate Finance Committee, and Republican Rep. Dave Camp, head of the House Ways and Means Committee—have so far kept all of their cards close to the vest. Scott Hodge, president of the Tax Foundation, a conservative leaning think tank, testified in favor of the idea before the Ways and Means Committee this March and says he met with a stony reception. “Most of the members were aghast,” he says, “It would have easier to suggest eliminating the charitable deduction.”

Congressional discussions about the budget this year have already proven rancorously partisan and a deal on the budget or on tax reform are not expected before next year.

The Conference of Mayor’s Mayor Smith, however, says the Conference will continue to visit members of Congress and the White House in an intense effort to kill any alteration of the muni tax exemption. Unless the Administration withdraws the proposal, he says, it is possible that a reduction or elimination of the exemption could find its way into law as part of “some last minute deal-making or horse trading. I don’t know what the likelihood is but as long as it’s still on the table you have to take it very seriously.”

—By Peter Carbonara, Special to CNBC.com