Bond Case Briefs

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Detroit Puts $1.1 Trillion of G.O.'s Under Scrutiny: Blooberg Muni Credit.

Detroit's bankruptcy has some investors fretting that the case will set a precedent for $1.1 trillion of U.S. general obligations. That hasn't kept the debt from beating revenue bonds for the first time since 2010.

A federal judge last week approved the city's record $18 billion Chapter 9 filing and said its pensions can be cut in bankruptcy. Detroit's emergency manager has sought concessions from creditors, including retirees and holders of $369 million of general obligations that the city had promised to repay using its unlimited taxing power.

The potential for losses on Detroit G.O.s means investors may now demand extra yield on obligations of localities struggling to balance budgets, said portfolio managers at T. Rowe Price Group Inc. and UBS Global Asset Management. Even with the prospect of added scrutiny, general obligations are outperforming revenue-backed munis in 2013, Bank of America Merrill Lynch data show. The bonds, the safest part of the municipal universe, are benefiting as investors favor their shorter maturities amid mounting bets that a growing economy will drive interest rates higher.

"The market will have to adjust how they price the risk, including how they judge general obligations versus revenue bonds," said Hugh McGuirk, Baltimore-based head of T. Rowe Price's muni group, which manages $20 billion. At the same time, "G.O. debt is typically shorter" in maturity, shielding it this year, he said.

Tax Backing

The borrowings account for about 30 percent of the $3.7 trillion municipal market, McGuirk said. Cities and states use the debt to finance projects such as bridges and schools, and repay investors with property-tax receipts or other local levies.

Detroit, which lost a quarter of its population in the decade through 2010, is an example of a shrinking tax base that can't support certain levels of debt, said Ebby Gerry, who helps manage $15 billion of munis at UBS Global Asset Management in New York.

General obligations "will need to be looked at with greater scrutiny," Gerry said. "The impression was that they'd just keep raising taxes and I'll always get my money on coupon payments and maturities. That's not necessarily the case if you have a horrible tax base."

Orr's Plan

In bankruptcy, general-obligation bonds are considered unsecured when they are backed only by a government's promise to repay, rather than any identifiable collateral or a revenue stream like water or sewer fees.

Before the city filed for bankruptcy in July, Kevyn Orr, its emergency manager, tried to get holders of unlimited general obligations to take less than 20 cents on the dollar. The proposal treated the securities on par with Detroit's other liabilities, including those to retirees.

Detroit may take "an aggressive posture" toward creditors, Jeffery Yorg, a Moody's Investors Service analyst, said in a Dec. 3 report.

General obligations of stressed municipalities may merit more scrutiny, Robert Kurtter, a managing director at Moody's, said Dec. 5 at a National Association of State Treasurers conference in New York.

A general-obligation pledge "simply may not mean anything," Kurtter said. "It will affect our view of credits that are under stress with high debt and pension burdens, particularly those that are in the speculative-grade space."

Better Year

Even as bondholders may be forced to take losses on Detroit general obligations, such debt has had a better year than revenue bonds.

The extra yield buyers demand to own revenue bonds instead of general obligations averaged about 0.97 percentage point for the past three months, the most since March 2012, Bank of America data show.

The bank's index of general obligations has lost 2.2 percent this year, beating the 3.3 percent drop for revenue bonds. It would be the first time for general obligations to fare better than revenue bonds since 2010.

Investor bets on Federal Reserve policy provide the backdrop for the reversal. As speculation has grown this year that an expanding economy will lead the central bank to curb its bond-buying program, shorter-maturity bonds have held their value the best, as have higher-rated securities.

The Bank of America general-obligation index has an average maturity of 12 years and a credit grade two steps below benchmark debt. For revenue debt, the average maturity is five years longer, and the rating one level weaker.

Revenue Effect

"As long-term returns have been hurt, then that would have a bigger effect on revenue bonds," McGuirk said.

General obligations have another appeal to investors: They are less prone to default than revenue debt, signaling that any Detroit precedent may have limited influence.

Of 443 issuers in default on payments as of Dec. 3, two — Detroit and Brighton, Alabama — are general obligations, Matt Fabian, a managing director at Concord, Massachusetts-based Municipal Market Advisors, said in an e-mail. The rest are backed by revenue such as from real estate developments and senior-living facilities.

California Treasurer Bill Lockyer said "big states and issuers" won't see any backlash from Detroit.

"Some investors will be nervous," Lockyer said after a panel at the treasurers' conference. "So OK, they don't buy Detroit. They don't buy some tiny hospital district issue that comes out every 12 years."

Market Week

In the municipal market this week, issuers plan to sell $11 billion of long-term debt with yields at a three-month high.

Top-rated 10-year munis yield 2.99 percent, compared with 2.86 percent on similar-maturity Treasuries.

The ratio of the interest rates, a measure of relative value, is about 105 percent, compared with a five-year average of 102 percent. The higher the figure, the cheaper munis are compared with federal securities.

Following is a pending sale:

New York state's Utility Debt Securitization Authority plans to sell $2.1 billion of revenue bonds this week, data compiled by Bloomberg show. Proceeds will refund a portion of the Long Island Power Authority's $7 billion of debt.

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