Dirt Bonds Lead Market in 2013 as Housing Rebounds: Muni Credit.

Builders in November started construction on the most homes in more than five years and housing prices are at their highest in more than seven years. Photographer: Craig Warga/Bloomberg

Municipal debt tied to real-estate development is set to be the best-performing part of the $3.7 trillion state and local-bond market this year as an improving housing market boosts the securities' earnings.

Land-backed debt, called dirt bonds, earned 1.1 percent through Dec. 23, more than any other area of the market, while all munis lost 2.6 percent, according to Standard & Poor's data. The obligations are the riskiest part of the muni market, accounting for almost half of non-payment defaults, according to Concord, Massachusetts-based Municipal Market Advisors. The segment also beat the market in 2012.

The securities have benefited from the housing market rebounding from the longest recession since the Great Depression, said John Miller, co-head of fixed-income at Nuveen Asset Management LLC in Chicago. Builders in November started construction on the most homes in more than five years and housing prices are at their highest in more than seven years.

"These things all help the performance of the underlying credit fundamentals of land-secured bonds," said Miller, who helps manage $90 billion of munis, including about $4.5 billion of dirt bonds. "This year, the economic recovery, to a great extent, is being driven by a better housing market."

Financing Construction

Tax-exempt debt tied to housing is gaining as the broader muni market is set for its first losing year since 2008. Benchmark 10-year muni yields in September reached their highest level in more than two years after Detroit's July bankruptcy filing, speculation that the Federal Reserve would end its bond-buying program and unease over Puerto Rico's economic struggles.

Land-backed munis are sold to help finance construction of residential developments and are repaid with assessment fees charged to homeowners. Much of the debt has been sold for home construction in Florida and California, Miller said.

When the housing market collapsed in 2006 some of the projects supported by muni bonds fell into payment default as demand for new homes slowed. As of Dec. 18, there were 441 active municipal defaults, 217 of them for land-secured debt, in which issuers hadn't made full payments, according to Municipal Market Advisors.

One example of the use of muni dirt bonds is a mixed-use development called Harbor Point in Stamford, Connecticut, which includes housing, retail and office space.

Florida ‘Taint’

The project sold $145 million of debt in 2010, a portion of which Nuveen holds. Tax-exempt bonds maturing in April 2039 and not graded by any of the three major credit-rating companies last traded Dec. 9 with yields as low as 6.18 percent, compared with 7.87 percent when the debt priced in January 2010, data compiled by Bloomberg show.

Investors demanded an average of about 4.22 percentage points of extra yield over benchmark munis to own the debt Dec. 9, compared with about 3.6 percentage points at the bonds’ original pricing.

The “taint” from the Florida housing market still affects dirt bonds, Miller said. Florida has had the most new foreclosure filings among all U.S. states in 11 of the last 13 months, according to RealtyTrack, which calculates housing defaults.

Nationwide, starts of single-family houses climbed 20.8 percent to a 727,000 rate in November, the most since March 2008, U.S. Census data show. Housing prices rose 13.3 percent in September from a year earlier, the biggest gain since February 2006, according to the S&P/Case-Shiller Composite-20 City Home Price Index.

Needing Housing

Michael Walls, who helps manage $1.8 billion of high-yield munis at Waddell & Reed Financial Inc., based in Overland Park, Kansas, looks for developments in areas with a need for new housing and a growing local economy.

“It’s knowing demand for the commercial project or the residential project,” Walls said. “You’ve got to go out and kick the tires.”

Dirt bonds don’t trade as often or in blocks as large as other types of munis, said Miller and Lyle Fitterer, who helps manage $31 billion of state and local debt at Wells Capital Management in Menomonee Falls, Wisconsin. That helped dirt bonds as portfolio managers sold more liquid tax-exempts this year, rather than land-backed debt, as investors pulled record cash from U.S. muni mutual funds.

“To a certain degree, the sector’s like the housing market — if your house doesn’t trade, there’s not a lot of price volatility,” Fitterer said.

Narrowing Spread

Land-secured debt may extend its gains in 2014 as the housing market benefits from projected economic growth, Miller said. The U.S. economy will expand 2.6 percent next year, according to the results of a Bloomberg News survey of 74 economists conducted from Dec. 6 to Dec. 11.

“If new issue supply is moderate and the existing credit quality of what you have out there in the secondary market is improving, both of those factors help to narrow the credit spread,’” Miller said.

In the municipal market this week, states and cities plan to sell about $12 million of long-term debt, Bloomberg data show. With a shortened week because of the Christmas holiday, it’s the slowest week of borrowing since at least 2002, according to Bloomberg data.

Benchmark 10-year munis yield 2.94 percent, down from a three-month high of 3.05 percent on Dec. 11 and compares with 2.98 percent on similar-maturity Treasuries.

The ratio of the interest rates, a gauge of relative value, is about 99 percent, compared with a five-year average of 101 percent. The lower the figure, the more expensive munis are compared with federal securities. It's the first time the ratio has been below 100 percent since November.

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