Bond Case Briefs

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Where Have All the Bonds Gone?

With a sizable portion of the municipal bond market focused on the August bankruptcy trial of the city of Detroit, many municipal bond investors are bumping up against a problem much closer to home: The supply of bonds is way down, driving prices up and yields down.

The municipal bond market is driven by new supply. While many bonds trade regularly, the vast majority are purchased and held to maturity — "put away," in the parlance of the trade.

Normally, that's OK. But the supply of newly issued bonds is down significantly this year, and demand is up, driven by investors, many of them hit with higher taxes, hungry for tax-advantaged investments. Supply Down. Demand Up.

On the supply side, municipalities nationwide through mid-June sold about $123 billion of long-term, fixed-rate bonds, down 20 percent from the comparable period in 2013. When combined with bonds that have matured or been called, the municipal market has actually contracted by approximately $111 billion since 2010, the biggest decline (peak to trough) since records began in 1945, according to Federal Reserve data.

Minnesota reflects the national trend, with the outstanding amount of muni debt down year-ove--year. We are, however, bucking the trend in new issues, with supply up by $600 million vs. the comparable period in 2013, to approximately $2.8 billion.

That sum, however, includes the roughly $460 million of debt sold for the new Vikings stadium; back out those bonds, and our total was up only about 6.4 percent over 2013.

What gives?

By all accounts, elected officials nationwide are still reluctant to incur debt. Things aren't so bad here in Minnesota. As our economy, one of the strongest in the United States, has improved, so have credit conditions for municipal bond issuers.

Consequently, credit rating upgrades, which lower borrowing costs, have outpaced downgrades through the first quarter this year vs. the last year, according to Moody's.

While some municipalities are still coping with strained finances, tax receipts for many municipalities, including the state of Minnesota, are up, and overall conditions are better.

Opinions about future supply vary widely, but the need for infrastructure spending at all levels of government — expenditures typically financed by municipal bonds — is clear. The question is when, and to what extent, will that take place?

One important result of this tight market has been higher bond prices, which pushes down yields to investors. On a capital gains basis, that has helped drive up the face value of bonds that trade, resulting in investment gains of nearly 6 percent on this class of assets in the first six months of 2014.

Lower Treasury bond rates also fed into this performance.

We do not expect these returns to be repeated in the second half of the year, but municipal bonds continue to look attractive relative to many fixed-income alternatives.

Beware of the potholes

That said, investors need to navigate carefully. Bargain hunters may be tempted to look hard, for example, at the bonds issued by cities such as Detroit, which has declared bankruptcy, and Puerto Rico. Be careful.

Detroit's bankruptcy trial starts Aug. 14. Early negotiations suggest some preliminary adjustments, but the trial could change all that.

As things now stand, Detroit's general obligation bondholders, who sit at the top of the credit ladder, are looking at about 74 cents on the dollar, while other bondholders stand to take a beating, some recovering as little as 11 percent of the face value of their bonds.

Meanwhile, the holders of Puerto Rico bonds look to be in for a wild ride. Puerto Rico is a big, big issue in the municipal bond market, although its problems have been known for quite a while.

This little island is carrying an enormous debt load — more than $70 billion — and it's burdened by a very weak economy, rampant crime and a declining population, which is only about 3 million.

Puerto Rico does not have bankruptcy laws like the United States. But a new law has just been enacted that would provide for a restructuring mechanism for the power, water and transportation authorities. Legal challenges have already been filed.

We counsel folks to avoid reaching for yield by taking on what can turn out to be an inordinate amount of risk. As the saying goes, let the trend be your friend. The general state of municipal finance has improved. Stick with quality issues. The wind is at your back.

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