Bond Case Briefs

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Driving Muni Bond Rally: Communities Reluctant to Borrow.

Rob Rapheal, president of the school board in Forest Lake, Minn., wants to tap the bond market to fix the community's aging public schools.

Earlier this year, he helped a team of parents, teachers and administrators put forward a proposal that aimed to raise $188 million to repair crumbling roofs, replace aging boilers and reduce debt-service costs.

"It was a real deal for the public," Mr. Rapheal said.

But the proposal was shot down in a special election, with 60% of voters rejecting the plan.

The vote reflects a force behind this year's rally in the $3.7 trillion municipal-bond market: states, cities and communities are unwilling or unable to borrow in the wake of the recession. That means the supply of securities available for investors is dwindling, driving prices higher.

"The market would welcome that paper, but if they can't issue it, we can't buy it," said Tom Metzold, vice president and senior portfolio adviser at Boston-based Eaton Vance Corp., which manages about $26 billion in municipal assets.

It isn't just voters constricting the market; state and city budgets in many regions remain austere since the recession ended in 2009 and officials may be reluctant to propose new taxes ahead of November elections. Others are concentrating on paying down unfunded pension obligations or other critical needs. Meanwhile, municipal-bond issuers already have refinanced large portions of their debt over the past several years, capturing low interest rates, and summer is typically a slow season for new bond sales.

As a result, there are many communities making the same choice as Forest Lake despite borrowing costs that are near generational lows. With or without input from voters, cities and states issued about $29.7 billion less debt during the first eight months of this year than in the same portion of 2013, according to data from the Securities Industry and Financial Markets Association, with about $203.5 billion issued through last month.

Many cities and states were burned in the financial crisis by bad deals on municipal bonds sold to pay for everything from highways in Massachusetts to renovations on Louisiana's Mercedes-Benz Superdome. Taxpayers refinanced billions in securities after auctions for variable-rate bonds collapsed, for example, and spent billions more to get out of derivatives that are often bought to hedge the same deals.

In 2006, politicians sought voter approval on a record $109 billion in bonds, according to Bond Buyer data. By 2009, that was down to $19.4 billion, with voters approving just $12.7 billion, the lowest amount since 1995. Presidential elections typically include many bond measures as public officials take advantage of high voter turnout, but 2012 resulted in the lowest value of new bonds of any presidential cycle since 2000. Last year, voters approved about $22.9 billion, around half the average of the previous 10 years.

“There’s a genuine demonstrated need for infrastructure, and yet states and municipalities are just extremely cautious about borrowing,” said Scott Pattison, executive director of the National Association of State Budget Officers. “From their perspective, revenue is coming in below expectations, growth is slow compared to before the recession, the feds are creating uncertainty, so we’re going to continue to be cautious.”

Water damage at the high school Jenn Ackerman for The Wall Street Journal
The caution is likely to persist, say some analysts. Municipal-bond issuance will decrease to as low as $175 billion in 2017, Tom Kozlik and Alan Schankel said in a Janney Montgomery Scott LLC research report. They attributed the stagnation to interest rates that will eventually rise, austerity measures, high fixed costs for local governments and the lack of broad public policy supporting public works.

“There is nothing politically sexy about infrastructure spending,” they said in the report.

Many municipalities are cautious to take on new debt because economic growth in their regions is still slow, said John Bonow, chief executive of Philadelphia-based PFM Group, which advises cities and states on bond deals.

Texas, which includes seven of the nation’s 15 most rapidly growing cities, has sold the most debt in the U.S.—some $20.7 billion worth of bonds through mid-July. By comparison, the state issued $30.9 billion in all of 2013. California, meanwhile, has sold only $19.8 billion in bonds in the same time, trailing the pace that gave it a nationwide-high $47 billion last year, according to Ipreo data.

Officials are postponing anything that isn’t critical or important to public safety for a year or two until economic conditions improve, said Jamison Feheley, head of banking for public finance at J.P. Morgan Chase & Co.

Even when public officials push ahead, voters are rejecting more debt, with the value of approved bonds falling to about two-thirds of those proposed in the three years immediately after the crisis, from an average of more than three-quarters in the three years prior. And while that total rose to 72.7% in 2013, school districts were still below that level and less likely to get voter approval than utilities, transportation or general-purpose debt, according to Bond Buyer data.

Voters in Neosho, Mo., have twice this year rejected a plan to raise property taxes to pay for a new junior high school. In central Ohio last month, two plans to improve facilities at local school districts went down in defeat.

In Forest Lake, the school board hasn’t had a bond referendum pass since Bill Clinton was president. The area is part of Minnesota’s Sixth congressional district, and represented in Washington by former presidential hopeful Michele Bachmann, known for taking a stance against raising taxes. Many Forest Lake schools are now about a half-century old, with antiquated fire and security systems and leaky roofs. A high-school running track hasn’t been usable in a decade. After a $24 million bond proposal failed in 2010, the district built a community task force that toured the schools and spent about eight months developing a plan for how to approach repairs and renovations.

Those included redesigning entrances for better security, closing outdated buildings, repairing roofs, replacing ancient boilers, merging two junior high schools and expanding the high school.

If voters had approved the debt, the district would have made all necessary repairs by 2018, adding arts facilities, a new pool, a track and a football field. The plan would have increased taxes on the average area household by about $200 a year, according to the district. The current levy generates about $850 per student, the lowest in the district's athletic conference.

The school district's superintendent Linda Madsen said the area's residents didn't oppose the plan in an organized way, and state legislators wrote letters of support to the local papers. But, as the results began to roll in on the evening of Election Day, she said it was clear the plan wouldn't pass.

The district's schools are making do by not using the track and planning to use fans instead of new air conditioning.

"Nothing's changed," Mr. Rapheal said. "The type of repairs we need to do are still there. Unless we address them, we're going to end up having catastrophic failures. Really, bonds are a very good way to finance building."

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