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Recession's Legacy Leaves U.S. State Bonds as Muni-Market Laggards.

Six years after the recession, U.S. state budgets have yet to fully recover, reserves are shrinking and more than a dozen governors want to raise taxes.

Investors have taken note: the return on state debt is on pace to trail the $3.7 trillion municipal bond market for a second straight year, according to Bank of America Merrill Lynch indexes. The extra yield bondholders demand to own state debt instead of top-rated munis is close to a three-year high.

Even as the growing economy mends state finances, officials are contending with rising retirement bills, health-care costs and the need to make up for previous budget cuts, according to a report Tuesday by the National Association of State Budget Officers. Such pressure has led firms including Morgan Stanley to recommend limiting holdings of state debt, saying governments are vulnerable to an economic slowdown.

"The headline emergency is over, but if you look at the numbers below the top line, there are still some significant challenges," said Robert Amodeo, who helps oversee $30 billion of municipal bonds for Western Asset Management Co. in New York. He predicts that state general-obligation debt will cheapen compared with benchmark securities.

Slow Recovery

States have been slowly recovering from the longest recession since the Great Depression, which caused tax collections to tumble and left pension funds reeling from investment losses.

The rebound hasn't been strong enough to give states the revenue needed to make up for previous spending cuts and keep pace with some expenses, said Scott Pattison, the executive director of the Washington-based budget officers group.

"It's just not enough money to cover those growing fiscal costs," he said. "It's a real worry going forward."

The $756 billion that states will spend in the current fiscal year, which ends in June for most, is still $24 billion, or 3.2 percent, below the 2008 peak, when adjusted for inflation, according to the report from Pattison's group. Budgets are set to expand next year by 3.1 percent, the smallest increase since the economy began growing again in 2009.

While fiscal stress on states including California and New York has ebbed, others are still struggling to balance budgets. Louisiana lawmakers voted to raise cigarette taxes and limit business subsidies to help close a $1.6 billion deficit next year. The drop in the price of oil cut Alaska's revenue by more than half. In Illinois, the Democrat-led legislature and Republican Governor Bruce Rauner remain at odds over how to eliminate the state's $6 billion shortfall.

Rising Bills

Investors are demanding 0.15 percentage point over top-rated munis to own state bonds, according to Bank of America Merrill Lynch indexes. That’s just short of the 0.16 percentage point reached last month, which was the most since June 2012. State debt has lost 0.23 percent this year, a steeper drop than the 0.11 percent decline for the muni market as whole. Last year, state bonds returned 6.9 percent, trailing the market’s 9.8 percent gain.

For states, mandatory expenses for schools and health-care programs are rising faster than tax collections, according to the report.

“It’s a simple math calculation that something’s got to give,” said Pattison.

Two dozen states, including Alaska and Ohio, are set to draw down cash reserves in the coming year, the report found.

‘Biggest Underweight’

Sixteen governors proposed tax and fee increases, while 12 sought cuts. If fully enacted, that would result in an increase of $3 billion. In the previous two years, governors moved to cut taxes and fees overall.
“State and local credit is our biggest underweight,” Michael Zezas, the chief muni strategist at Morgan Stanley, said in an e-mail Monday.

Zezas said in a research note to clients in April that states are “vulnerable” to the next economic downturn. He said investors “should be more circumspect” about buying state debt because prices relative to other securities are unlikely to improve.

Western Asset Management’s Amodeo expects the gap between yields on state bonds and benchmark debt to widen. He has been buying debt backed by specific revenue pledges, instead.

“Investors are recognizing that they should be paid more,” he said.

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