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Puerto Rico Fails to Sink Muni Market's Best Rally in Six Months.

It doesn't matter if Puerto Rico defaults, at least not to investors in the $3.6 trillion municipal market.
With the island just days away from potentially missing a Public Finance Corp. debt payment, state and local-government bonds are poised for the biggest monthly gain since January, Bank of America Merrill Lynch data show. The securities have returned 0.64 percent in July, outpacing the 0.45 percent increase for the broader U.S. fixed-income market.

Munis overcame a rocky start: After Puerto Rico Governor Alejandro Garcia Padilla said the island can't afford its $72 billion debt load, individuals yanked $1.2 billion from muni funds in the week ended July 1, Lipper US Fund Flows data show. The money began flowing back in as munis rallied, showing the lack of fallout from the commonwealth's long-brewing crisis.

"The municipal market is going to prove very resilient in the face of a default on the PFC bonds in Puerto Rico," said Tom McLoughlin, head of municipal fixed-income at UBS Wealth Management Americas, which oversees $1.1 trillion. Investors have "psychologically ring-fenced Puerto Rico because we've been talking about it for two years."

Solid Footing

For the muni market, the Federal Reserve and overseas turmoil were more powerful than Puerto Rico. State and local debt joined Treasuries in climbing this month on signs the U.S. central bank will raise interest rates gradually and as investors sought a haven from Greece's debt crisis and China's stock-market swings.

The monthly rally, munis' first since March, comes as states and cities gain from rising real-estate prices and a growing economy. State and local tax revenue rose 4.2 percent during the first quarter from the year earlier, according to Census Bureau figures. Only one borrower rated by Moody's Investors Service has defaulted since 2013.

"The overall municipal market is on solid footing," Peter Hayes, the head of municipal debt at New York-based BlackRock Inc., the world's biggest money manager, said in a blog post Thursday. "Creditworthiness is strong and attractive relative yields should continue to draw demand."

That's made Puerto Rico an outlier. After years of borrowing to pay bills as its population declined, officials by Sept. 1 may propose the biggest debt restructuring ever in the muni market. The Caribbean island may miss a bond payment for the first time on Aug. 1, when $58 million is due from the Public Finance agency.

Cutting Holdings

Investors had time to prepare. Puerto Rico was cut to junk in early 2014, and mutual funds have been paring their holdings of its bonds. Hedge funds now own more of the securities than mutual funds, according to estimates from Morningstar Inc. and Barclays Plc.

The shift has cushioned the impact as the island's crisis escalated over the past month.
"The potential for wider market disruption seems fairly muted," said BlackRock's Hayes.

Yields on top-rated 10-year munis were 2.28 percent on Thursday, down from 2.38 percent at the start of the month. Seizing on a slide in borrowing costs, states and cities issued $36 billion of debt in July, keeping sales on pace this year to be the most since at least 2003, according to data compiled by Bloomberg.

Weathering Distress

Both are signs that the market is able to weather pockets of distress such as Puerto Rico and Chicago, whose credit rating has tumbled as it contends with soaring bills for its pension funds.

"What the market is getting better at is differentiating those risks," said Lyle Fitterer, who oversees $38 billion as head of tax-exempt fixed-income at Wells Capital Management in Menomonee Falls, Wisconsin.
By some measures, state and local debt is still cheap.

Ten-year munis yield about the same as similar-maturity Treasuries, compared with 96 percent since the start of 2014, Bloomberg data show. A higher ratio signals state and city debt — which is exempt from federal income taxes — offers greater relative value.

For the highest earners, the yield on AAA 30-year munis is equivalent to about 5.8 percent on a taxable security, Bloomberg data show. Similarly dated corporate debt yields 4.09 percent, while 30-year Treasury bonds yield about 2.94 percent, according to data from Moody's Investors Service and Bloomberg.

"Muni bonds on a tax-adjusted basis are still by far the best value out there," said Krishna Memani, chief investment officer at OppenheimerFunds Inc., which oversees $24 billion in state and local-government debt.

Bloomberg

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July 30, 2015 — 9:01 PM PDT Updated on July 31, 2015 — 5:48 AM PDT