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Connecticut Tax Bonds Draw Buyers Losing Faith in State Pledges.

Connecticut bond investors have more faith in the tax man than in the full faith and credit pledge of the state.

Though the extra yield investors demand to own the state's general obligations instead of top-rated debt is almost the highest on record, its $840 million bond sale this week is drawing interest from Conning, Eaton Vance Management and Nuveen Asset Management. That's because the debt, which will pay for transportation projects, is backed by dedicated taxes on motor fuels, oil companies and retail sales — none of which can be touched by lawmakers until bondholders are paid.

"If you're going to make an investment in Connecticut, this is a credit that should be strongly considered," said Paul Mansour, head of municipal research at Conning, which oversees $11 billion of the debt, including some state bonds. "There's no appropriation required. So if there's ever a budget stalemate, there's less risk of a delay in getting paid."

Connecticut reflects a shift in the $3.6 trillion municipal market, where investors have given greater scrutiny to securities backed only by a government's promise since Detroit foisted losses on bondholders following its 2013 bankruptcy. This year, debt funded by legislative appropriations was tarnished when Puerto Rico chose to default and Illinois's budget stalemate caused the credit rating of Chicago's convention center agency to be cut from AAA to near junk.

Malloy's Maneuver

Connecticut Governor Dannel Malloy signed a law that boosted the share of the sales tax for transportation-project bonds this year and walls it off from the money spent by the legislature, an effort to spur spending on public works. As a result, oil company and sales taxes are being sent to a special fund, providing added security to investors.

Connecticut, the wealthiest U.S. state, has an Aa3 credit rating from Moody's Investors Service. Only Illinois and New Jersey are ranked lower. That's because the state's economy has rebounded slowly from the recession, its pension system is the third-most underfunded nationwide and it has the most debt per resident.

The extra yield investors demand to buy 10-year Connecticut general obligations rather than benchmark municipals has climbed to 0.47 percentage point from as little as 0.27 percent in January, data compiled by Bloomberg show. That spread is near the widest since at least January 2013, when the data begin, signaling that the debt is viewed as relatively riskier.

The transportation bonds have retained their value. Debt issued a year ago that's due in September 2026 traded last week at a spread of 0.49 percentage point, unchanged from the average over the past five months, data compiled by Bloomberg show.

"We do prefer this type of revenue stream versus the state of Connecticut G.O. pledge," said Michael

Hamilton, who runs a $284 million Connecticut open-end mutual fund at Nuveen Asset Management. He owns some of the transportation debt. "I have some room to buy if the deal comes a little wider, given the state has widened out as well."

Malloy made improving Connecticut's infrastructure a focus of his budget, which also cut spending and raised taxes on corporations and the highest earners. To fund his initiative, 0.3 percent of the 6.35 percent sales tax will be funneled toward the revenue bonds this year. The share will ramp up to 0.5 percent by the 2018 fiscal year, according to bond documents.

Railway, Roads

Proceeds from the new bonds, which are set to be sold Thursday, will fund improvements to the New Haven Rail Line, the I-84 expressway and the Pearl Harbor Memorial Bridge.

Fitch Ratings last week ranked the bonds AA, the same as Connecticut's general obligations. The credit rater in July raised the state's outlook to stable from negative, pulling it back from the brink of a downgrade, citing a budget for the next two fiscal years that appears balanced.

Carl Thompson, an analyst at Eaton Vance, said he agrees with Fitch's more optimistic assessment. Mansour, the analyst at Conning, said his outlook for the state is still negative: His company's May ranking of the fiscal health of states put Connecticut sixth-to-last.

Yet both agree the transportation bonds are a potential buying opportunity.

"Despite similar ratings as the state, I think that Connecticut's special tax bonds are a much stronger credit," Mansour said. "The state has accelerating debt service and pension obligations. With these bonds, you have much more predictable and stable expenses."

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by Brian Chappatta

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