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## **Municipal Market Contracts at Record Pace as Refunding Dominates.**

For an unprecedented fifth-straight year, investors saw more bonds leaving the municipal market than being sold by states and localities.

Net issuance is ending the year at about negative \$15 billion, according to data compiled by Bloomberg. The figure is calculated monthly by subtracting amounts being redeemed early or maturing from what was issued, based on the date at which interest begins to accrue. Though some analysts predicted a pickup in bond sales for infrastructure projects, nearly two-thirds of the almost \$400 billion in debt offered in 2015 refinanced higher-cost debt, suppressing market growth, Bank of America Merrill Lynch data show.

More than six years after the recession ended, state and local governments remain in an age of austerity as they grapple with pension obligations and other expenses. Bond sales fell off the record pace to start the year during the final months of 2015 as the Federal Reserve prepared to increase borrowing costs for the first time in almost a decade. That flipped net issuance into negative territory.

The scarcity of new debt has kept benchmark muni yields near the lowest relative to U.S. Treasuries in more than a year as demand for tax-exempt bonds outstripped the supply. That's been a boon to investors: After flat returns through the first six months of the year, munis ended 2015 up 3.5 percent, compared with 0.6 percent for Treasuries. Investment-grade corporate debt lost 0.8 percent and high-yield company securities plunged 4.7 percent.

"The net negative supply in 2015 has really come to roost as we close out the year," said Peter DeGroot, a strategist at JPMorgan Chase & Co. Next year is "still a highly supportive environment for municipal securities in terms of relative performance to taxable fixed-income counterparts."

Individuals own the majority of the \$3.7 trillion municipal market either through specific bonds or mutual funds. They usually invest in the bonds as part of a strategy to cut their tax burden, meaning they're likely to reinvest their debt payments back into the asset class. The negative issuance figure is even larger when assuming individuals put all that cash back into munis, DeGroot said.

As investors flocked to munis in 2015, the debt became expensive to Treasuries on a relative basis. The ratio of 10-year AAA rated muni yields to those on federal debt is about 87 percent, compared with an average of 101 percent over the past five years, Bloomberg data show.

Even with relatively low yields, investors are likely to continue putting their money into munis, particularly the tax-free interest payments they get from their current holdings, said Chris Mier at Loop Capital Markets.

"There's a core, base demand for municipal bonds," said Mier, chief strategist at Loop in Chicago. "For higher tax-bracket individuals, they're a core element of any portfolio and that isn't expected to change much in 2016."

Long-term muni sales are poised to decline by about 1 percent in 2016 from this year's level, according to a survey of 10 underwriters released last week by the Securities Industry and Financial Markets Association. Yet refunding will fall to 55 percent of issuance from 62 percent in 2015, according to the report.

With fewer refinancing deals, the market may grow in 2016. Without accounting for coupon reinvestment, net supply will be \$50 billion in 2016, according to DeGroot at JPMorgan. That's in line with the \$45 billion estimate of Vikram Rai, head of muni strategy at Citigroup Inc. Michael Zezas at Morgan Stanley says net issuance could swell to \$99 billion.

Even with the potential market growth, munis should still post positive returns in 2016, according to the trio of strategists.

"It's a number that sounds large compared to what we just experienced, but in the entire history of the muni market, it's not a number that is indigestible," Zezas said. "There's a substantial amount of deferred capital needs throughout the municipal infrastructure system."

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