
States Losing Ability to Borrow at Record Lows as Issuance Rises.

States from California to Massachusetts are paying the highest premiums in three months when selling bonds as a flurry of tax-exempt debt issuance is met with slowing inflows into municipal mutual funds.

Municipal issuers plan to sell $10.6 billion of long-term fixed-rate debt this week, more than any five-day period since Nov. 16, data compiled by Bloomberg show. Massachusetts sold $1.1 billion Thursday, in the second-biggest deal of the week.

"When the new issue guys start making calls, they don't get as a receptive of a phone call as when the market's running hot and when the funds are getting a ton of cash," said Matt Dalton, chief executive officer of Rye Brook, New York-based Belle Haven Investments, which oversees $4 billion of municipal bonds.

The spread, or extra yield, investors demand on Massachusetts debt above AAA rated bonds is 0.22 percentage point, or 0.065 percentage point more than the three-month average, according to data compiled by Bloomberg. Last week, California spreads reached a three-month high of 0.31 percentage point.

Yield premiums on state general-obligation bonds are rising as investors pay closer attention to growing pension deficits and retiree health care liabilities, according to Bob DiMella, co-head of MacKay Municipal Managers at the investment advisory firm MacKay Shields LLC.

U.S. state pensions had 74 percent of assets required to meet obligations to retirees in fiscal 2015, down from 77 percent in the prior year, Wilshire Consulting said Tuesday. On top of that, new government accounting standards may reveal that state and local governments that previously addressed pension funding still face risks or remain underfunded.

Negative Outlook

Massachusetts, which ranks second behind Connecticut for the highest per capita income, had its credit-rating outlook changed to negative by Standard & Poor's in November because the state was drawing down reserves even as the economy was recovering from the Great Recession. Reserves have declined as spending has outpaced revenue. S&P rates Massachusetts' general obligation bonds AA+, the second-highest investment grade.

Massachusetts is projecting reserves of $1.35 billion for the fiscal year ending June 30, about $220 million less than the previous year, according to S&P. The state has also suspended transfers of excess capital gains tax revenue to a budget stabilization fund.

"In general, we expect states to set aside during good times, extra revenues into a budget stabilization fund for use during the downturn," said S&P analyst David Hitchcock "The concern is here, they're having strong growth in revenue and they're not building up reserves for the bad times.”

Fund Flows

In February, municipal bond mutual funds netted $4.8 billion, a $200 million decline from the previous month, according to Lipper US Fund Flow data. Money has flowed to muni mutual funds for 21 straight weeks.
“Over the month of February that money has been placed so things are slowing down a little bit, which has caused spreads to widen,” Dalton said. “There’s still cash and cash is still coming in, but it’s not piling up like it was,” Dalton said.

In a Wednesday order period for individual investors, Massachusetts sold at least $160 million of the bonds, said Assistant Treasurer Sue Perez. The commonwealth was expecting retail orders of $120 million to $150 million, she said.

The higher premiums were reflected in the prices set Thursday after mutual funds and other big buyers submitted orders. The 10-year bonds were sold for yields of 2.08 percent, or 0.32 percentage point more than top-rated bonds with the same maturity, according to data compiled by Bloomberg. Thirty-year callable bonds were priced to yield 3.02 percent.

Supply next will be lighter than initially anticipated, she said. As of Wednesday, states and local governments plan $6.4 billion in long-term bond sales, according to data compiled by Bloomberg.

“That may actually work to our favor,” said Perez.

Massachusetts Governor Charlie Baker, a Republican, proposed a $39.6 billion budget in January that deposits $206 million of excess capital gains tax revenue into the budget stabilization fund, a positive development, according to S&P. The amount is $150 million less than the $356 million that would have been deposited under a state formula.

“It wouldn’t be the full amount but it would be at least an increase that they haven’t seen for three years,” Hitchcock said.

Massachusetts’ economy, anchored by higher education, health-care and technology sectors, is performing better than the nation as a whole. The state’s unemployment rate was 4.7 percent in 2015 compared with 5 percent for the U.S.

Even so, the commonwealth is burdened by a growing debt service and pension costs. The pension fund had 61 percent of assets required to meet obligations to retirees in 2015 compared with 78.6 percent in 2008, according to S&P.

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