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Despite Strong Muni Market, GO Munis Turn Risky: BlackRock

The muni bond market is now questioning the willingness and ability of some issuers to make payments on general obligation bonds: BlackRock's Peter Hayes

Municipal bonds, a favored fixed income asset class among high net worth investors, are experiencing strong demand this year despite the debt troubles of Puerto Rico, New Jersey and Illinois and gains that, unlike last year's, are lagging those of Treasuries and investment grade and high yield corporate bonds.

Flows into muni bond funds topped \$22 billion for the first five months of the year, and muni fund assets reached a record high of \$632 billion as of June 1, according to Lipper. Demand from foreign borrowers seeking higher yields is adding to demand. Year-to-date investment grade munis have returned just over 3%, capturing most of the gains that BlackRock's Municipal Bonds Group had been expecting for the full year.

Peter Hayes, a managing director and head of the group, said Wednesday the firm is now reassessing its outlook but expects another 1.5% return for the remainder of the year.

Despite the relatively strong performance of municipal bonds overall, however, he expects the problems of issuers like New Jersey and Illinois, which have large fixed costs for pensions but not enough revenues to pay them, will likely get worse, and general obligation bonds will suffer the most.

The GO category of muni bonds, backed by the full faith and credit of the issuer, have traditionally been considered the gold standard and safest type of issue among muni credits, but that view has been upended by the problems dating back at least to Detroit, said Hayes.

"The muni bond market is now questioning the willingness and ability to pay of some entities to pay," said Hayes. He doesn't expect that sentiment will abate anytime soon.

"Two things have to happen first," said Hayes. "You have to have significant pension reform and cut benefits or you've got to pay for it. Many of the entities have the ability to pay for it to some degree but politically they don't want to."

Those politics could potentially change in some states if elections result in one party rule of the governor's office and legislature, but in the meantime the muni market "will continue to question the GO structure," said Hayes. And spreads in such states, which also include Pennsylvania and Connecticut, could widen further.

About Illinois which recently announced plans to borrow \$550 million for capital projects, Hayes said the state should be penalized by muni market participants "in some way, by almost not giving them any access to the market....Think about it — they're a state without a budget, they refuse to pass a budget, they have the lowest funded ratio on their pension of any state, and yet they're going to

come to market and borrow money.”

ThinkAdvisor

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