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Even Puerto Rico Rallies in Muni Market Wells Says Is Too Frothy.

The world's bubble-like bond rally has found its way to the U.S. municipal market.

The price of junk-rated Ohio tobacco debt that may never be paid in full has climbed 14 percent since the start of the year. New York City's Albert Einstein College of Medicine sold $175 million of unrated securities in January at par for a yield of 5.5 percent. Now, they're worth 122 cents on the dollar and yield 2.8 percent, according to data compiled by Bloomberg. Even those issued by Puerto Rico, which has been defaulting on a growing share of its debt, have returned 8.4 percent.

"What has changed in the last six months that makes the credit worth more?" said Lyle Fitterer, who oversees $40 billion as head of tax-exempt debt for Wells Capital Management and has been buying higher-rated bonds instead. "I'll tell you what's changed: the money flowing into high-yield funds."

That corner of the $3.7 trillion municipal market, home to bonds backed by hospitals, speculative real estate developments and settlement payments from tobacco companies, has turned into a mad scramble. With interest rates hitting record lows around the world, investors are grasping for anything that promises bigger returns, driving a run up that will leave them at risk if the pendulum swings the other way.

As money poured into municipal mutual funds for the last 39 straight weeks, $8.3 billion — or more than one-third of the total — went to those focused on high-yield securities, according to Lipper US Fund Flows.

As a result, the extra payouts investors demand to compensate for risk has shrunk. Excluding Puerto Rico bonds, the difference in the yields of investment-grade and high-yield munis has narrowed to about 2.7 percentage points, 0.65 percentage point less than the average since 1995, according to Barclays Plc.

Securities that can be bought in blocks of $1 million or more, such as new issues and tobacco debt, are in high demand. When a private consortium borrowed $2.4 billion to finance the redevelopment of LaGuardia Airport's Central Terminal Building, investors placed 10 times as many orders as bonds available, according to LaGuardia Gateway Partners, the manager of the project. The securities were rated Baa3 by Moody's Investors Service, one step above junk.

John Miller, who oversees Nuveen Asset Management's $14 billion high-yield muni fund, said a more accurate gauge of the risk of high-yield securities is to compare them to AAA rated tax-exempt bonds. By that measure, high yield municipals — excluding Puerto Rico — are trading at 2.4 percentage points more than top-rated bonds, or 0.1 percentage point less than the historical average.

"That's attractive for having already eliminated the most volatile part of the market and the market that has the highest default risk," said Miller, co-head of fixed income for Nuveen in Chicago. "Outside of Puerto Rico, we're not seeing real stress."

Tobacco bonds, which are backed by payments from cigarette companies under a 1998 settlement with 46 U.S. states, have benefited as smokers plowed savings from lower gasoline prices into cigarettes.

Moody's projects 80 percent of the securities may default, based on historical declines of 3 percent to 4 percent in U.S. smoking. Cigarette shipments, which determine the payouts that states used to fund the debt, increased 1.9 percent last year, the most ever, according to the National Association of Attorneys General.
"That's a big swing," said Miller.

Last year's bump is an anomaly, said Ken Shea, a senior analyst with Bloomberg Intelligence in Skillman, New Jersey. In the first three months of the year, shipments declined 5.5 percent from the previous quarter, according to Management Science Associates, a data and analytics firm.

The muni market is pricing high-yield bonds with the belief that interest rates will stay low for a long period and the economy will grow at a moderate rate, said Wells's Fitterer.

He said that forecast may not be far off the mark. But with prices already having rallied so much, Fitterer is buying the least risky securities and letting his fund's high-yield holdings decline as bonds mature. For example, a AA- rated Metropolitan Transportation Authority bond maturing in 2044 is trading at an average yield of 2.3 percent, just 0.5 percentage point less than the unrated Albert Einstein bonds. Einstein forecasts a $62 million loss in 2016, and 60 percent of its revenue comes from grants, contracts and gifts.

"We all know that at some point the markets will turn," he said. "You have to look at the portfolio and say, 'Gee, am I getting paid enough to take the incremental credit risk?'"

The indicated yield on Wells's high-yield fund is 2.79 percent, compared to 6.35 percent for the Oppenheimer Rochester High Yield Municipal Fund, the highest of 40 such funds tracked by Bloomberg.

"We've always told people if we don't see value in high yield we're going to go where we see the best relative value," Fitterer said. "If people don't want to buy my fund, I'm fine with that."

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by Martin Z Braun

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