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How the Muni Market Sails Past Disaster.

How do they do it?

Municipal bonds maintained a trajectory to the record highs reached last week as a series of bankruptcies, budget debacles and defaults failed to damage investor confidence in the industry as a whole.

Municipal analysts and experts say decades of improvements – from enhanced disclosure and heightened enforcement to increased transparency and growth of technological advancements – have helped the broader tax-exempt market build immunity to isolated debacles in distressed municipalities.

Improved credit surveillance and information flow, advancements in online trading platforms, better market technicals, and the economy have helped investors shrug off a range of fiscal debacles from today's credit crises in Puerto Rico and Illinois, to the historic $18 billion Detroit bankruptcy in 2013 and the $2 billion Orange County, Calif., default back in 1994.

Robert Doty, president of Annapolis, Md.-based municipal securities consulting firm AGFS attributes munis' staying power to better disclosure practices and market discipline enforced by the Securities & Exchange Commission.

"The market continues to function even though we have a major issuer in the market – Puerto Rico – defaulting, and Illinois is teetering," he said.

Disclosure and Market Stability

Some analysts say the stability of the market is tied to economic progress and the general credit worthiness and demand for tax efficiency in the $3.7 trillion municipal market.

"As long as the tax base and the population remain near current levels the market will continue to let Illinois kick the can down the road," Michael Pietronico, chief executive officer at Miller Tabak Asset Management, said in an interview last week.

Overall, the municipal bond market has awarded lower borrowing costs to issuers with strengthening finances, and that has helped the market retain its positive nature in the midst of recent credit and fiscal crises, Pietronico said.

"Issuers believe market access is a right when in fact it is a privilege," he added.

"Detroit is a prime example of that phenomenon as they leaned on the rest of the state of Michigan to gain market access when in many minds they were bankrupt and unable to fund their own liabilities."

"Puerto Rico understands that 'penalty box' quite well, while states such as Illinois continue to pay a yield premium in a market starved for yield," Pietronico added.

Doty, who has over 45 years of experience in the municipal industry, said disclosure and transparency enforced by the SEC have continued to improve, protecting today's market in the face of credit debacles.

"We have a lot of guidance and the market has improved considerably," he said, referring not only to SEC disclosure and enforcement practices, but also the guidance and market support from the National Association of Bond Lawyers and National Federation of Municipal Analysts.

Problematic credits, such as the state of Illinois, Chicago, and New Jersey are viewed as "one-offs" that are isolated from the general market, according to Jeffrey Lipton, managing director and head of fixed income research at Oppenheimer & Co.

"These are high profile names that take up significant headline real estate, and for the most part, should not deliver very many surprises given the information flow and heavy analytical coverage," Lipton said. "The muni market is a $3.6 trillion entity with an extremely high percentage of bonds meeting timely payment of principal and interest. The asset class also experiences much higher recovery rates as compared to corporate bonds."

David Litvack, managing director and head of tax-exempt research at U.S. Trust, Bank of America Private Wealth Management said the municipal market is "benefitting from a very favorable technical environment, in which demand for tax exempt income is overwhelming available supply."

New deals are oversubscribed, and low nominal rates have caused credit spreads to tighten over the last few years as investors search for yield, he said.

"We believe Puerto Rico's credit problems have not resulted in contagion to the broader muni market, because the commonwealth is seen as an outlier," Litvack added.

Puerto Rico's fiscal and economic declines with associated bond defaults are not expected to have a systemic impact upon the broader municipal market, because its fiscal story has been widely publicized in recent years, according to Lipton.

"There has been a substantive shift in trading participants and commonwealth bond ownership to more sophisticated investors such as hedge funds and distressed buyers," Lipton said in an interview last week. "We continue to believe that any temporary market sell-off that may be triggered by a Puerto Rico event could give rise to buying opportunities," he said.

Historical Comparison

Decades of industry advancements – some as basic as information flow – have helped the market evolve and strengthen.

"In the 1970's the market still had physical certificates and coupons to clip," John Donaldson, director of fixed income at The Haverford Trust Co. said last week. "Today, municipal bonds trade and settle like any other issue."

Transparency has evolved and contributed to better market participation.

"We can see the details on any public issue from our Bloomberg terminal; we can access updated financial reports with a click," Donaldson said. "Back then it could easily take a week to get information necessary to make a decision on a credit you did not own.

"Price information in the form of MSRB trading data is also transparent. Secondary market pricing in the 1970’s was anything but transparent,” he added.

The advent of official statements on general obligation deals helped to define the practice of increased disclosure to and education of investors over the last three decades, Doty of AGFS said.

The market in recent years has fared significantly better than it did back in the mid-1970s when New York City faced default on its GO debt in 1975 due to the ill effects of a stagnant economy, according to Doty. It narrowly avoided default after the Teacher’s Union agreed to invest $150 million to buy Municipal Assistance Corporation bonds, followed by a $1.3 billion in federal loans to the city for three years.

“The market was extremely disruptive when New York City had its problems, but it’s a contrast, and the difference in my view is that investors can distinguish between credits and back then they couldn’t,” Doty said. “Official statements weren’t being used very much for GOs, and New York City didn’t use one until 1975.”

Now, traders are able to value so-called troubled bonds based on the specific risk and arrive at yields that satisfy the investor community – something that couldn’t be done in the 1970s because the pricing and credit information wasn’t easily and readily accessible, Doty of AGFS said.

Despite the distressed outliers, investors can rely on municipal bonds for capital preservation, portfolio liquidity, tax-exemption, as well as strong credit quality, Lipton said.

“The muni market of 2016 has, in some ways, become an extension of 2015, but overall performance is poised higher this year,” he added. “Muni bond buyers have been nicely rewarded just by staying invested and clipping their coupons,” he added. “Year-to-date, Barclays shows munis have returned 4.49%, versus 5.52% for Treasuries.”

Lipton said a so-called “perfect storm” may create an attractive municipal bond market that may lead to even lower yields – even with the ongoing debacles.

“A more accommodative Fed, the Brexit vote – with all of the associated uncertainty – variability in economic data, strong market technicals, and an enduring competitive edge are all converging,” Lipton said. “This dynamic is expected to extend the market’s 38 consecutive-week run of positive mutual fund flows, despite noted retail and institutional resistance to currently lofty prices.”

The Bond Buyer

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