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Tobacco Debt Is Addictive for Yield-Starved New York Muni Buyers.

In other times, state and local-government bonds backed by the legal settlement with cigarette makers might scare off would-be buyers, given the risk of default if Americans keep kicking the habit.

But with tax-exempt yields holding near the lowest on record, the securities have rallied, delivering returns of 12 percent this year, double the gain for U.S. stocks and more than any other segment of the municipal-debt market, according to Standard & Poor's indexes. The demand led seven New York counties to offer $294 million of the bonds Thursday, this year's first issue of securities once stung by speculation they'll leave investors burned as smoking declines. The 10-year bonds were priced to yield of 2.11 percent, just 0.6 percentage points more than top-rated securities, according to data compiled by Bloomberg.

"The security is coming to market at a time when there isn't a lot available offering any yield for New York investors," said Ted Jaeckel, who co-manages the $5 billion BlackRock Strategic Municipal Opportunities Fund.

The bonds have been lifted in part because cigarette shipments, which determine the size of the annual settlement payments that back the securities, were little changed in 2015 as low gasoline prices gave consumers more money to spend. That marked a shift from prior years, when sales fell faster than expected, leaving much of the debt with junk ratings because of the likelihood that they won't be paid off when they come due.

"We still have a big allocation to the sector," said David Hammer, head of municipal bonds in New York for Pacific Investment Management Co., which has pared the share devoted to such bonds because of the price rise. "We see a lot of value in it compared to others."

Tobacco bonds were first issued more than a decade ago to allow governments to get an advance on the settlement, which was to help them pay for the health-care costs related to smoking. Since then, tobacco consumption has dropped more than some estimated, with the difficulty of accurately predicting the annual payouts driving Fitch Ratings in June to pull its ranking on the securities.

The New York counties, in offering documents circulated to investors ahead of the sale, said the timely repayment could be jeopardized by regulations, litigation, competition and tax increases, among other factors.

The bonds were sold for Broome, Dutchess, Onondaga, Rensselaer, Ulster, Oswego and Sullivan counties. Mark LeVigne, deputy director of the New York State Association of Counties, which worked with the borrowers, declined to comment.

The sale comes comes after New York Attorney General Eric Schneiderman struck a deal to end a long-running legal dispute over the 1998 settlement in October, freeing up money for the state, counties and New York City that had been held in escrow. S&P Global Ratings gave the new securities preliminary ratings from A on shorter maturities to BBB, two steps above junk, on those due as late as 2045.

"It's in a fairly robust ratings range, that could make it attractive for individual investors," said BlackRock's Jaeckel.

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