

# Bond Case Briefs

*Municipal Finance Law Since 1971*

---

## Municipal Bond Markets after the US Presidential Election: When the Dust Settles.

Municipal bond markets are healthy, especially relative to overleverage in the US Treasury and US corporate bond markets, according to Peter Coffin, president of Breckinridge Capital Advisors.

A 30-year veteran municipal bond analyst and portfolio manager, Coffin gave his thoughts on major trends in the US municipal bond markets, including possible scenarios in the post-election world, at the CFA Institute Conference: Fixed-Income Management 2016.

Favorable supply and demand dynamics, combined with greater transparency and disclosure by municipalities, have recently made these markets more attractive to investors. However, Coffin issued a caution on the “chronically distressed” state and local governments that continue to “kick the debt can down the road” until the inevitable day of reckoning.

### **Evolution of the Municipal Market Since the Financial Crisis**

The US municipal bond markets have been “changing for the good” in terms of disclosure and reporting since the financial crisis, Coffin observed.

Prior to 2008, it was sometimes difficult for active municipal bond managers to demonstrate their value-add to performance. Because of widespread municipal bond insurance, Coffin said, moral hazard and complacency on the part of issuers and investors had crept into the municipal bond markets.

Everything changed during the financial crisis with the near demise of municipal bond insurers. Investors had to adapt to a new framework. “Today investors are much better equipped,” Coffin noted. There are more repositories of financial information — from specialty research and data providers to ratings agencies. “In 2011, only 60,000 municipalities filed financial statements,” he said. “This year, it’s over 100,000 and growing.”

Municipal bonds were the one part of the bond world that didn’t over-lever in the period leading up to the financial crisis, and more recently, during the zero interest-rate policy (ZIRP) period. One of the primary reasons for this: State and local municipalities have constitutional or statutory restrictions on the amount of debt they can issue. “In the 1840s, when half the states defaulted to Europe, many state and local constitutions were rewritten so it would never happen again,” said Coffin. These laws have endured, so voter referendums are required to issue debt — a definite disincentive for local officials.

### **Supply and Demand Factors: Different from Other Bond Markets**

Annual municipal bond issuance is still relatively moderate compared with corporate bonds and Treasuries, with the overall size of the market at \$3.7 trillion. “We’re only replacing what’s being retired,” Coffin said.

With over 40,000 issuers, municipal bond markets are unique. After six months, individual issues trade infrequently or not at all. Retail investors buy the bonds for tax-free income and are often reluctant to sell and convert their investments to a taxable capital gain. This long-term perspective adds to the stability and resilience of these markets. "To me, it's like standing on the bank of a river," Coffin said. "There's a constant flow of new issues. We're looking upstream to see what's coming. Then it trades and goes away."

On the demand side, strong cash continues to flow into the sector, bolstered by demographic trends. Baby boomers with their eye on their retirement years are looking for investments with "a little more income and a little less risk," Coffin said. Over the long term, this bodes well for the bond market.

Of course, tax free does not mean risk free. In our low interest rate environment, Coffin worries that retail investors are stretching for yield without understanding the duration risk, as mutual fund data suggests many have moved out of money market funds into higher yielding bond funds. "I don't know how well equipped they are to cope with the risks," he said.

### **Volatility, Regulation, and Liquidity**

Volatility in the municipal bond market comes from several factors. "It's a challenge for dealers to hedge municipal bond risks because there's no investable index," Coffin said. "Trading in these markets is a little sloppy and they're more prone than other bonds to be oversold or overbought." As with the corporate bond sector, the Dodd-Frank Wall Street Reform and Consumer Protection Act and other banking regulations have caused dealers to reduce their municipal bond inventories. Coffin is concerned about Wall Street's capacity to help in a liquidity crisis.

Short-term municipal bonds have experienced a decrease in value due to the SEC's Money Market Fund Reform Rules that were supposed to help the stability of shorter-term securities. Investors have pulled \$64 billion out of municipal money market mutual funds, preferring to invest instead in government-only money market funds not subject to the reform rules requiring floating net asset values, liquidity fees, and gates in certain conditions. "Municipal bonds experienced an unusual 45 bps increase in the one-year spot rate this year," Coffin observed.

Regulators have also been pushing hard on local government officials. One example occurred when the SEC brought fraud charges against the mayor of Harrisburg, Pennsylvania, after he gave a speech that painted "too rosy" an economic forecast.

### **Opportunities in Taxable Municipals**

Larger muni-bond issues, such as bonds issued by the Greater Orlando Aviation Authority in October 2016, usually come to market with a tax-exempt portion, an alternative minimum tax portion, and a taxable portion. Because of their relative attractiveness and higher yield, taxable municipal bonds are more interesting to institutional investors, particularly foreign investors that can list them as US government bonds on their balance sheets. Coffin observed, "If we have sweeping tax reform (a high priority of the Trump administration), you may see more taxable municipals coming."

Coffin also noted that in the taxable municipal bond market, investors can expect liquidity on par with the tax-free munis issued by the same entity. He added that during the financial crisis, taxable municipal bond values actually held up better than corporate bonds and had less correlation with equities. The significantly lower historic default risk of taxable munis versus corporates accounts for their relatively solid performance.

### **General Obligation (GO) vs. Revenue Bonds**

Recent significant haircuts to creditors in the distressed general obligation (GO) bond market had investors turning their focus to revenue bonds. “In bankruptcy situations, outcomes are much less certain today for GOs,” Coffin said. The Detroit bankruptcy was a case in point. There, a federal judge affirmed that bankruptcy law superseded state laws protecting pensions and contracts. But Coffin noted that after the GO bonds and other Detroit debt were restructured, bondholders recovered just a little over 70 cents on the dollar. “I tell people, I have a front-row seat to the epic struggle between labor and capital,” he said, “and round one has gone to labor.”

Coffin advises investors to be very selective and opportunistic in the “chronically distressed” issues. BCA Research deemed the combined obligations of certain states — New Jersey, Hawaii, Connecticut, Illinois, Kentucky, Alaska, and Massachusetts — the “elephant in the room.” Coffin noted that “these states are woefully underfunded,” taking into account the high debt, underfunded pension obligations, and other post-employment benefits (OPEB) such as health care.

Not only does New Jersey have high combined obligations, but the state was also hit with a subpar economic recovery that led to a political impasse. The state negotiated with the state employees’ unions to extend retirement ages and reduce benefits and cost of living allowances in exchange for the state’s promise to make scheduled contributions to the pension funds. The New Jersey government failed to make the promised pension contributions and said it was not under a contractual obligation to do so. The unions sued and the state supreme court upheld the state’s right not to fund. “These problems will ultimately get resolved, but right now they’re getting worse and worse,” Coffin said.

Resolution needs to begin soon. As Coffin stated, the “hope is once we get through the US presidential election, there is meaningful restructuring.”

Despite the chronically distressed issuers, Coffin applauded the recent resiliency of the municipal bond markets. “Municipal bond investors were able to look through situations like San Bernadino, California; Jefferson County, Alabama; Stockton, California; and Puerto Rico,” he said. He doesn’t believe this will be the norm going forward, however. “Bankruptcy is a very unlikely scenario for the vast majority of bonds,” Coffin observed. “Politicians can’t just repudiate their debt.” In most cases, the law will focus on the municipality’s “full faith and credit” obligation and say that taxes should be raised.

### **Municipal Bonds as the Most Sustainable Investment**

Coffin never takes the tax-exempt status of municipal bonds for granted, but with favorable supply and demand dynamics and a modestly improving US economy, the sector continues to look attractive. Property taxes are improving as a result of increased real estate values at the local level. Sales and excise taxes, particularly in the oil and gas states, are cyclical, which has been reflected in widening spreads. Coffin is more cautious and selective in health care, a sector that has been performing well.

He encourages investment managers to talk more about municipal bonds as sustainable investments. “What could be better than investing in local infrastructure, health care, and education?” he asked. “We need to talk more about the positive impact municipal bond financing has on a local community. It allows small communities access to capital, and that’s a good thing for our country.”

### **Enterprising Investor**

14 December 2016

By Julie Hammond, CFA

Copyright © 2026 Bond Case Briefs | [bondcasebriefs.com](http://bondcasebriefs.com)