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Risk Rises in Municipal Bonds.

Money has poured into high-yield munis even as investors have pulled money from the sector overall

When The Spires at Berry College sought to borrow money to build retirement homes recently, the Georgia-based senior-living center sold municipal bonds.

Even though investors typically consider retirement homes riskier borrowers, and these bonds came without a credit rating, there was enough investor demand that the project landed interest rates below officials' expectations.

There has been a surge in sales from the riskiest parts of the $3.9 trillion market for state and local debt. Retirement communities like The Spires, charter schools and student-housing projects were among sectors in 2018 that issued a greater share of municipal bonds than at any time since the financial crisis.

That increase came even as bond yields, which rise as bond prices fall, climbed for much of past year. Overall municipal-bond issuance fell about 25% in 2018 from the prior year to the lowest level since 2013, according to data from the Securities Industry and Financial Markets Association. Money flowing into municipal mutual- and exchange-traded funds also slowed.

The riskiest sectors in the municipal bond market—including junk and unrated borrowers in categories that tend to have the highest rates of default or impairment—made up about 20% of total bond sales in 2018, up from 17.4% the prior year, according to Municipal Market Analytics data. That was the most since 2008, when they made up 24% of issuance.

Municipal investors in December even welcomed Detroit's first stand-alone bond sale since the city's bankruptcy. Demand was so robust that yields on the junk-rated deal came in below city leaders' expectations, they said. They were still high enough to lure investors.

"The yields got pretty attractive," said Daniel Solender, director of municipal bonds at Lord Abbett & Co. "There was a good range of opportunity available."

State and local debt remains historically safe for investors, with few defaults, because bonds tend to be backed by issuers' taxing power or revenue from essential services like water or power. Many retirement communities, charter schools and hospitals can use the market to sell tax-exempt debt because they play important community roles, but they aren't government entities—and analysts said a downturn could cause financial difficulties for some.

About 4% of continuing-care retirement-community bonds were in default as of Jan. 1, compared with the 1.8% of the broader market, according to MMA. Excluding Puerto Rico, which is in restructuring talks with creditors, 0.3% of municipal bonds were in default.

Junk and unrated municipal issuers continued to borrow in December, traders say, even as market turmoil halted bond sales by junk-rated corporations for 40 days through Jan. 10—the longest

stretch in more than two decades.

Still, there was enough demand for higher-yielding debt that Adam Heffernan, a consultant who works with The Spires, said the retirement community's final bonds priced with lower yields than expected, by at least a quarter of a percentage point for some bond maturities.

High-yield municipal bonds posted a 4.8% total return in 2018, counting price changes and interest payments, above the broader market's 1.3% return, according to Bloomberg Barclays data. Money poured into high-yield munis even as investors pulled money from the sector overall, Lipper data show.

Nicholos Venditti, a portfolio manager overseeing municipals at Thornburg Investment Management, said he had largely avoided lower-rated and riskier bonds. But at the end of 2018, as equity markets roiled and investors fled high-yield corporates, at least one deal looked attractive for him: a bond issuance linked to natural gas.

"It's not a sector that we held prior to late November or early December," Mr. Venditti said. "When we saw the market for those change, we did take on a little bit of a position."

Issuance of these bonds more than quintupled in 2018 from the year prior, hitting at least a nine-year high, the MMA data shows.

Some worry the riskiest bonds could be hardest hit if concerns about slowing economic growth, which have rattled markets lately, and stock turbulence rise.

Adding to some investors' worries is the concentration of the high-yield municipal market. Nuveen and Invesco Ltd., which recently acquired Oppenheimer Funds Inc., hold at least 40% of assets in municipal mutual and exchange-traded funds classified as high-yield by Morningstar Direct, according to a Wall Street Journal analysis of the data.

"Imagine a situation in which high yield hiccups….they're both selling the same things at the same time," said Mr. Venditti. "Where is that stuff going to go?"

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by Gunjan Banerji

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