Bond Case Briefs

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The Muni-Bond Mania.

Look who's benefiting from the limit on state-and-local tax deduction.

Democratic politicians in the states love to blame the GOP tax reform for blowing holes in their budgets even as they quietly benefit from the new limitation on state-and-local tax deductions. Lo, investors seeking to reduce their tax liability are gobbling up municipal bonds, driving down yields and reducing government borrowing costs.

Municipal bond funds are experiencing near-record inflows. More money poured into muni funds during the first eight weeks of this year than during the same period since at least 2006. No longer able to deduct most of their state-and-local taxes on their federal returns, investors are seeking alternative vehicles that offer protection from the tax man.

Surging demand for tax-exempt investments and low interest rates have let state and local governments borrow more cheaply. The 10-year AAA tax-exempt muni bond this week traded below 2%—about 60 basis points lower than the 10-year Treasury and 170 below a similarly rated corporate bond. Even low-quality muni debt like Illinois bonds boast yields as low as 3.6%.

Beyond the federal tax dispensation, most states exempt their own agency and local government debt. Hence the biggest beneficiaries of the muni-bond rally have been high-tax states, especially those with precarious finances. Eight of the 10 biggest bond issuers during the first quarter were in California, New York and Connecticut. New Jersey and the junk-rated city of Chicago were close behind.

Last week Chicago increased the size of a bond offering to take advantage of swelling demand and low interest rates. The spread on a 10-year Chicago bond relative to a top-rated muni has slid 125 basis points since 2017 despite the city's deteriorating finances and soaring pension payments. Investors last week also inhaled $440 million in bonds issued by Illinois, which is rated one notch above junk.

Democrats can't be blamed for trying to take advantage of the muni-bond mania. Illinois Gov. J.B. Pritzker has proposed selling $2 billion in bonds (which would be taxable) to inject into the state's insolvent pension funds that are only 40% funded. The idea is the state can borrow at a rate of around 5% and then earn 7% on pension-fund investments. Sweet.

But the state has already borrowed more than $17 billion to prop up its pension funds, and the interest-rate arbitrage transfers risk from state taxpayers and workers to investors. Recall that investors in Puerto Rico, Detroit and Stockton, Calif., were eventually burned by similar schemes.

One question is whether investors are underpricing the risk of muni bonds due to their tax exemption and the low interest-rate environment. This is especially concerning since rating agencies Moody's and Fitch recalibrated their muni-bond ratings in 2010. According to a new accounting study by MIT researchers, the subsequent grade inflation "appears to have yielded significant reductions in interest costs paid by issuers" while bringing in more business and higher fees for the raters.

Misaligned incentives may also be distorting investment decisions. Businesses could often put investor cash to more productive use than municipal governments, which in many cases are borrowing for projects that private industry could do at lower cost. Most muni-bond buyers are merely looking for a higher after-tax return, but they should remember that there’s no such thing as a risk-free investment.

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