Bond Case Briefs

Municipal Finance Law Since 1971

Everybody Wants Muni Paper.

If you enjoyed Detroit debt, you'll love Chicago schools bonds.

Yield-hungry investors have been piling into riskier assets, and not only speculative stocks like GameStop. For an example of how negative real interest rates are distorting prices, behold the municipal bond market.

Last month investors snapped up $560 million in bonds issued by junk-rated Chicago Public Schools (CPS). The district's 10-year bonds were priced at 1.94% and the 20-year at 2.24%—a mere 117 to 105 basis points above the AAA muni benchmark yields. As the district's finances have deteriorated, its borrowing costs have plunged. Go figure.

Five years ago Chicago schools had to pay an 8.5% yield—a 580 basis-point penalty above AAA—to sell debt amid concerns that soaring labor and pension costs would drive the district into bankruptcy. Asked at the time whether the district would be able to borrow again, then CPS CEO Forrest Claypool replied: "I don't know."

What a difference a pandemic and Federal Reserve commitment to keep rates at near zero make. Muni bonds are thinly traded and usually held in portfolio for duration. Most buyers need fixed-income assets that produce steady returns, which explains the ravenous appetite for higher-yielding muni bonds.

"Buyers are just starved for yield and the inflows into high-yield funds have been astronomical for at least the last couple of weeks," one muni-market analyst explained to Bond Buyer. Increased demand has made it cheaper than ever for state and local governments to borrow and has compressed price spreads between high- and low-rated bonds.

Some muni bonds are also tax exempt, which makes them attractive to investors expecting Democrats to raise taxes. Tax revenue has been surprisingly buoyant due to the housing and stock-market booms, so investors may be shrugging off worries about defaults.

Municipal tax revenue declined by a mere 1% on average in 2020, according to investment manager Nuveen, while states and cities have received hundreds of billions of dollars in federal cash. Chicago schools received twice as much money from the last $900 billion relief bill as its budget projected. Now Democrats want to pass another $350 billion in state and local government aid.

Financial advisers are urging municipalities to take advantage of the rock-bottom rates to refinance debt. Pension obligation bonds, which were popular amid low interest rates and the stock-market rally in the 2000s, are back in vogue. S&P Global Ratings says pension bonds more than doubled in 2020 and are sizzling now.

Not so long ago, investors were burned by these bonds. Then as now, municipalities issued debt at low rates and used the proceeds to backfill pension funds. The interest-rate arbitrage seemed to benefit muni borrowers and creditors. But when stocks tanked in 2008, taxpayers were on the hook

for bond payments and increasing pension contributions to cover their pension shortfalls. Puerto Rico, Detroit, and Stockton and San Bernardino, Calif., reneged on their pension-bond debt in bankruptcy. Lucky for politicians, investors have a short memory.

While Illinois and California account for most pension bonds issued, municipalities in Arizona including Tucson, Flagstaff and Pinal County have recently turned to the bond market to cover their pension holes. Pension bonds aren't tax exempt, but yields are still attractive to investors. The city of Flagstaff's deal last summer with a 2.7% interest rate was 3.7 times oversubscribed.

Meantime, pension funds have been pouring into equities and riskier assets to cover shortfalls and make up for low yields on their fixed-income assets. "As interest rates remain low, so do bond yields, making safer investment options less attractive for pension funds needing to meet targeted returns," S&P recently warned.

How this all ends is hard to predict, but a fair guess is that some new Stocktons and Detroits are likely. The Fed has declared that the cost of borrowing is essentially nothing, government and corporate debt are soaring as a result, and eventually a price will be paid.

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