[Bond Case Briefs]

Municipal Finance Law Since 1971

[Muni Bond Prices Rally After Infrastructure Bill Leaves Out Market.]

Yield on a 10-year tax-exempt triple-A muni bond has fallen 8% since Oct. 28

Municipal bond prices rallied over the past two weeks as investors abandoned hopes for a flurry of new bonds from Congress's $1 trillion investment in U.S. infrastructure.

The yield on a 10-year tax-exempt triple-A muni bond has fallen 8% since Oct. 28, according to ICE Data Services. Bond yields fall as prices rise.

The municipal market has largely been left out of the infrastructure package signed by President Biden Monday, as well as Democrats' follow-up social-spending and climate proposal, disappointing investors looking to buy new bonds and local governments trying to manage their debt loads. The package could still help strengthen city and state balance sheets, another possible reason for investor optimism.

Muni market wishlist items included in an earlier draft of included federally subsidized interest payments and a plan to restore the federal tax exemption for early refinancings.

"They left out the tried and true mechanism for building local infrastructure in America," said Ben Watkins, director of Florida's Division of Bond Finance.

In the long term, any investment in roads, sewers and trains is generally seen as good for the market since it helps boost municipal credit. The $1 trillion package could also eventually lead to more bond issuance because some projects will receive partial, rather than full, federal support, and states and cities will need to pay for the rest.

"In many cases the local contribution will come from municipal bonds," said Patrick Brett, head of municipal debt capital markets at Citigroup and chair of the Municipal Securities Rulemaking Board, the muni bond industry's self-regulatory organization.

But any immediate market impact will be muted. Congress's decision to scrap the municipal bond proposals represents a move by federal officials toward paying directly for projects, rather than standing back and ensuring states and cities can borrow cheaply for infrastructure while leaving the details to the locals.

States, cities, counties and school districts borrow at reduced rates in the nearly $4 trillion muni market because investors don't have to pay federal—and often state—taxes on the interest. Local officials retain wide discretion over the projects themselves.

A $3.5 trillion package considered in the House Ways and Means Committee in September included a measure based on the 2009-10 Build America Bonds program. State and local governments sold taxable Build America Bonds to a wide pool of buyers and the federal government paid a portion of the interest cost. That program spurred a record $273 billion in new borrowing in 2010, 54% higher than the yearly average over the past decade.

“It’s a great tool to have in the tool kit,” said Dallas Chief Financial Officer Elizabeth Reich, who urged a congressional committee to revive the program in March. The Omni Hotel in downtown Dallas was financed with the help of $388 million in Build America Bonds, Ms. Reich said.

Congress particularly disappointed participants in the supply-starved muni market with its decision not to restore municipal governments’ ability to refinance debt early at tax-exempt rates. That tool was eliminated in the 2017 tax overhaul to save the federal government money and mitigate the cost of tax cuts.

As a result, the many municipalities that rescheduled debt payments amid a pandemic-induced cash crunch over the past two years had to refinance at higher taxable rates.

Before the 2017 law change, cities and states could use tax-exempt borrowing when they wanted to refinance before a bond’s agreed-upon call date to cut interest costs or put off payments. They would issue a second set of tax-exempt bonds, invest the proceeds in safe, short-term securities, and then use those funds to make payments on the older bonds. It is a move that makes the most sense for borrowers when short-term rates are high relative to long-term rates.

But because both sets of bonds remained outstanding until the first set could be refinanced, and both provided investors with interest exempt from federal taxes, the federal government lost out on additional tax dollars. The Joint Committee on Taxation estimated that restoring advanced refunding would have cost the federal government $15 billion over the coming decade.

Municipal borrowers, for their part, could likely have reduced their interest costs, the reason the eliminated bill provision was a favorite of city finance chiefs and state treasurers. Ms. Reich estimated that Dallas saved $147 million with tax-exempt advanced refinancing between 2007 and 2017.

Money managers meanwhile said they would have welcomed an influx of new tax-exempt debt, even if it meant foregoing a bump in the value of their current holdings.

“You want to have a decent amount of supply to create a healthy market with opportunity,” said Dan Solender, director of tax-free fixed income at asset manager Lord Abbett.

The Wall Street Journal

By Heather Gillers

Updated Nov. 15, 2021 4:35 pm ET