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Defaults Are Quickening in Muni Bonds in Warning Sign for High-Yield Investors.

- **Time between issuance, impairment about half 2014 level: MMA**
- **Trend could blunt demand for riskier issuance, Fabian says**

Defaults and impairments are coming at a faster clip in the $4 trillion municipal-bond market, a potential warning sign for investors in junk munis, the best-performing sector of state and local-government debt.

The trend comes against a backdrop in which riskier issuers have gained more market access and investors awash in cash have grown more comfortable with weaker protections as yields remain well below historical averages. For muni deals that do become impaired, the time between issuance and such an event has tumbled to 32 months on average, less than half the level seen in 2014, Municipal Market Analytics data show.

The phenomenon holds for both risky and safer sectors as asset managers across the spectrum face reinvestment pressure. But weaker issuers have the most at stake, as broadly accelerating impairments could erode the segment's performance, crimping demand and making it harder for troubled borrowers to recover.

"More defaults and impairments, happening faster after issuance, could blunt the tip of high-yield demand," said Matt Fabian, a partner at MMA. "And if high-yield demand pulls back, it means less available rescue financing, so more defaults."

In MMA's definition, impairment refers to bonds in default or those that have tapped emergency means or violated a covenant.

Year to date, Bloomberg Intelligence data show that over $4.4 billion of securities have faced distress or default. In the week ended Thursday, seven deals totaling $102 million joined the ranks.

Munis' exceedingly low level of defaults relative to corporate debt, along with the improving U.S. economy, a wave of federal aid and talk of higher income taxes, have helped drive investor interest in junk offerings.

Muni Haven

In a year when munis overall have offered a haven in fixed income, earning about 1.5%, high-yield has been a standout, earning 7.7% in 2021, Bloomberg index data show.

The cash flowing in "doesn't just intensify demand, it also forces buyers to capitulate on credit conditions that they would normally require," Fabian said.

Those weaker underwriting conditions, such as sufficient reserves, contribute to the shrinking default window, he said. It's also easier for riskier projects to access capital through entities like conduits, and low yields have driven investors into more and more speculative deals.

The rise of passive investing and increased diversification has helped larger funds insulate themselves against defaults and distress. But for smaller asset managers with less liquidity and diversification, struggling deals can carry more weight.

“If you’re a small, relatively concentrated asset manager, you have to be more careful than you used to be,” Fabian said.

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