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Rising Rates Reduce Appeal of Taxable Bonds for Muni Issuers.

- **Taxable refundings down 57% in 2022 as savings 'evaporated'**
- **State and local taxable debt sales overall drop 39% this year**

States and localities are shying away from selling taxable bonds, a popular tool in the last two years, as rising interest rates reduce the chances for cost savings, especially from refinancing old debt.

Municipal issuers have sold $19.5 billion of long-term federally taxable bonds year to date, a 39% decrease from the same period a year ago, according to data compiled by Bloomberg. Sales of taxable munis surged in 2020 and the first half of 2021 to peak at almost a third of the primary market, before slowing to about 17% currently, according to Bloomberg data.

The Federal Reserve has begun to raise rates as part of a long-signaled plan to combat the highest inflation in four decades, and in doing so largely erased any savings governments could get from selling bonds to refinance outstanding debt. Taxable refunding bond sales have dropped almost 57% in 2022 from the year-ago period, and when tax-exempt refinancings are included, the decline is 33%, Bloomberg data show.

"Issuers are sensitive to interest rates and costs savings have evaporated," said Matt Thomas, portfolio manager for Belle Haven Investments. "That takes a huge chunk of the supply out of the market."

Kalamazoo, Michigan, for example, was planning to sell $76 million of taxable bonds to refinance debt in mid-March, but shelved the deal after rates jumped, said Warren Creamer, a managing director at Troy, Michigan-based MFCI LLC, an adviser on the proposed sale. The transaction is on hold as "the market continued to move away from us," Creamer said.

"Rates have gone up to a point that the difference between the debt service on the old bonds and the new bonds isn't enough to proceed with the transaction," he said. "We were hoping that at some point we would start to see a new normal."

Sales of all types of long-term municipal bonds this year are down about 6.4% to $113 billion. The yields for AAA muni securities maturing in 10 years on Wednesday reached the highest since March 2020, while 10-year Treasury rates hover around the highest since 2019.

An uptick in taxable sales to levels seen the last two years may be difficult without a sharp drop in interest rates, said Brian Barney, a managing director for Parametric Portfolio Associates. Compared with traditional tax-exempt municipal bonds, the taxable version offers higher yields to investors and can be used for projects ineligible for tax-free financing.

The segment will continue to play a significant role in the municipal market given investors looking for taxable income can tap into sales from muni issuers rated, on average, AA versus BBB corporate sellers, he said.

“It’s a big box in the muni market,” Barney said. “It still holds credence and I wouldn’t say this down tick in issuance pulls back the buying base.”

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By Shruti Singh and Danielle Moran

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