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State-Local Governments Proving Market Doubts Wrong: Muni Credit

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By Michelle Kaske

May 7 (Bloomberg) -- U.S. municipal bond yields are back to where they were in 1967, defying forecasts that the $3.7 trillion market's biggest rally in three years was near an end.

States and cities are refunding the most debt in at least five years. As a result, investors have fewer new bonds to purchase even as the largest wave of money in two years is surging into muni mutual funds. The appetite for the safety of local-government debt has grown since March on signs the U.S. economic rebound is cooling while state finances improve.

Municipal debt has earned 3.5 percent this year through May 3, beating the 0.2 percent gain for Treasuries, according to Bank of America Merrill Lynch indexes. It's the best annual start for munis since 2009.

"You're seeing more demand for municipal bonds than we would have initially expected at this part of the economic cycle," Neil Klein, who helps manage $1.2 billion in fixed income assets at Carret Asset Management in New York, said in an interview. "The strength of the municipal market is a bit surprising."

Since last year, Wall Street banks such as Citigroup Inc. and JPMorgan Chase & Co. have forecast a jump in municipal issuance after sales dropped in 2011 to the lowest since at least 2004. Klein was among investors predicting in January that Treasuries might beat munis.

Four Straight Weeks

Instead, state and local debt earned 2.6 percent that month including interest and price changes, to 0.5 percent for federal bonds, according to Bank of America Merrill Lynch indexes. Then, after a one-month hiatus in March, the muni rally came back even stronger.

Top-rated tax-exempt bonds due in 10 years have gained for four straight weeks, the longest streak since December, according to a Bloomberg Valuation Index. Their 1.88 percent yield is the lowest since February, after ending last year at 1.78 percent. A Bond Buyer index of 20-year yields has fallen to levels not seen in more than four decades.

Sliding interest rates have spurred municipalities from California to Illinois to refinance. About 60 percent of the $120 billion of bonds sold this year has been for refunding, data compiled by Bloomberg show. The ratio, the highest since at least 2007, was about 40 percent at this point in 2011.

Net Supply

The refinancing wave and projected redemptions may exceed the supply of new bonds for a second straight year, Citigroup strategists George Friedlander and Vikram Rai said last month.

With issuance of at least $340 billion and redemptions rising, "the net supply of bonds issued in 2012 is likely to be negative once again," they wrote in a report.

Individual buyers, who own about two-thirds of municipal debt, have also been pouring in. Investors have added $10.5 billion to muni funds this year, the most since an 18-week span through early April 2010, according to Lipper US Fund Flows.

They have been lured in part by signs municipal finances are stabilizing almost three years after the 18-month recession that ended in 2009.

More than half of U.S. states project ending this fiscal year with cash surpluses, the first time since the start of the recession that so many will have extra funds, according to the National Conference of State Legislatures.

Defaults Drop

Twenty-one issuers have defaulted for the first time this year, compared with 29 in the same stretch of 2011, according to Municipal Market Advisors in Concord, Massachusetts.

A drop in U.S. Treasury rates amid concern that European economies are weakening has also helped depress municipal yields, said Michael Pietronico, who manages $730 million of munis as chief executive officer of Miller Tabak Asset Management in New York.

Ten-year Treasury yields touched a three-month low of 1.87 percent last week as U.S. companies added the fewest jobs in six months, heightening concern the economic expansion is slowing. Euro-region services and manufacturing output contracted more than initially estimated in April, a measure showed last week.

"The perception in late March changed once again that perhaps all is not good over in Europe and the global economy may be losing momentum and here you go, rates are back down again," Pietronico said in an interview.

Following are descriptions of coming sales:

COLUMBIA UNIVERSITY in New York City plans to issue $100 million of taxable bonds as soon as this week to finance capital projects and refund debt, according to sale documents. The longest maturity for the bonds is 2042. JPMorgan is the underwriter. Standard & Poor's rates the bonds AAA. (Added May 7)

MASSACHUSETTS is set to issue $419 million of debt secured by gas-tax revenue through competitive bid as soon as May 8, according to sale documents. The bonds are special obligations of the state, payable from pledged revenue and not general- obligation debt. Proceeds will help finance bridge replacements and repairs. Moody's Investors Service rates the bonds Aaa.
(Added May 7)

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