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Fewest Defaults Since ’09 Belie Detroit Insolvency: Muni Credit

By Michelle Kaske
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U.S. localities are defaulting at the slowest rate since at least 2009, underscoring that municipalities nationwide are seeing fiscal gains even as Detroit is on the brink of a record-setting bankruptcy.

From California to New York, 26 local borrowers missed bond payments for the first time in the first half of 2013, down from 45 a year earlier and 58 in the same period of 2011, according to Municipal Market Advisors. It’s the slowest annual start since the Concord, Massachusetts-based research firm began tracking such failures in 2009.

While Detroit faces insolvency and Stockton, California, last year became the biggest U.S. city to seek court protection, the risk of payment defaults in the $3.7 trillion market is still “extremely low,” said Matt Fabian, a managing director at MMA. With the U.S. economy extending a rebound from the recession that ended in 2009, state tax collections are recovering and housing prices are at a seven-year high.

“A lot of the fiscal stress that was there over the past couple of years is starting to improve,” said Neil Klein, who helps oversee $1.2 billion of fixed income at Carret Asset Management in New York. “As the U.S. economy gets better, so will states and municipalities.”

Rally Fuel

Improving local finances helped fuel a nine-quarter rally in municipal debt starting in 2011, the longest in two decades, Bank of America Merrill Lynch data show. While broad fixed- income losses since May halted the gains, local governments’ borrowing costs are still close to the lowest in decades.

An expanding economy helps localities repay obligations in full and on time. State tax collections have risen for 12 straight quarters, according to the Nelson A. Rockefeller Institute of Government in Albany, New York. Home prices in 20 cities rose 12.05 percent in April from the same month last year, the biggest annual gain since 2006, the S&P/Case-Shiller index shows.

U.S. gross domestic product may grow about 1.9 percent this year and by 2.7 percent in 2014, the fastest pace since 2006, according to the median forecast of analysts surveyed by Bloomberg News.

Dollar Tally

Even as the number of first-time municipal defaults falls, the tally is rising in dollar terms because of a handful of issuers. Localities have failed to repay about $7.6 billion in 2013, the most for the first half of the year since at least 2009, MMA data show.

Debt sold by issuers that have long faced fiscal challenges, such as Detroit, Stockton, and Alabama's Jefferson County, accounted for the bulk of the increase, according to Fabian.

"These are the ripening of long-running legacy problems that developed well before the recent financial crisis and recession," Fabian said.

Detroit's tax base has shrunk as the city of about 700,000 residents has lost almost two-thirds of its population from a postwar peak in 1950, according to a May report from Kevyn Orr, the city's emergency manager.

Orr is working to close a $386 million deficit and reduce long-term debt of at least $17 billion by cutting benefits and restructuring obligations. His proposal to avert a record municipal bankruptcy includes halting payments on $2 billion of munis.

Jefferson County, which filed the largest U.S. municipal bankruptcy in 2011, plans to exit Chapter 9 this year by slashing $1.2 billion in principal payments to holders of defaulted sewer-related debt.

Beating Corporates

Municipalities are still defaulting less frequently than corporate borrowers, according to a Moody's Investors Service assessment of issuers it rates. From 1970 to 2012, an average of 5.7 percent of munis that were sold a decade or more earlier and had a junk rating defaulted, compared with 33.9 percent for company debt.

With munis on pace for their first weekly gain since May, New York's Metropolitan Transportation Authority offered about $334 million of tax-exempt debt. The agency postponed the issue last month as yields climbed.

The Securities Industry and Financial Markets Association recommended that trading stop at 2 p.m. New York time today for the U.S. Independence Day holiday, and resume on Friday, July 5.

Interest rates have spiked on speculation the Federal Reserve will slow its bond purchases as the economy improves.

Benchmark 10-year munis yield about 2.75 percent, after the interest rate reached 2.96 percent last week, the highest since April 2011, data compiled by Bloomberg show. Similar-maturity Treasuries yield about 2.47 percent.

Higher muni yields give buyers the potential for more income even as borrowers are becoming less risky, Klein said.

"We're actually seeing more investors looking to seize opportunity by grabbing high yields and better quality," Klein said.