Bloomberg

California Debt Upgrade Fuels Rally Past Treasuries: Muni Credit

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By Michelle Kaske

Feb. 1 (Bloomberg) -- The municipal-bond market is staging its best performance in a year as rising demand for tax-free income and an upgrade of California's debt outweigh the busiest borrowing wave since 2010.

Localities borrowed about $24 billion through Jan. 30, up 52 percent from a year earlier and the most January offerings since 2010, data from Bank of America Merrill Lynch and Bloomberg show. Still, the $3.7 trillion market earned about 0.7 percent through Jan. 30, compared with a loss of 1.1 percent for Treasuries, according to Bank of America data. The advantage to munis was the biggest since January 2012.

As three-quarters of U.S. households faced higher taxes this month, muni mutual funds added $4.4 billion, the most since 2009, Lipper US Fund Flows data show. Debt-holders also received $32 billion of principal and interest to reinvest, said John Hallacy, Bank of America's head of muni research. The appetite for local debt got an extra boost after Standard & Poor's yesterday raised California for the first time since 2006, to A.

The higher rating "will have an immediate positive impact" by improving the perception of the market's strength, said Neil Klein, who helps oversee $1.2 billion of fixed income at Carret Asset Management in New York. "Investors were looking for a process or a philosophy on how you can take states that appear to be struggling and turn the table."

Munis Outperform

The January performance built on two straight years in which munis outpaced Treasuries as they proved a more stable haven amid Europe's lingering debt crisis. Tax-exempts earned 7.3 percent in 2012, compared with 2.2 percent on federal debt, according to Bank of America data.

About 77 percent of households saw their tax bills rise after Congress in the first week of January ended a cut in the payroll levy, according to the nonpartisan Tax Policy Center in Washington. Lawmakers also boosted income-tax rates on households earning $450,000 or more to 39.6 percent from 35 percent.

"There is still a tremendous value in owning municipal bonds as tax rates go up at the state and federal level, said Klein. "Municipal bonds become that much more attractive."

California Rally

Debt of California rallied after the move by S&P. The company cited an improved fiscal footing after voters approved tax increases championed by Governor Jerry Brown. The state has $102 billion of gross tax-supported debt, the most in the nation, according to Moody's Investors Service.

California tax-exempt bonds due in September 2042 traded with an average yield of 3.3 percent, or about 0.4 percentage point above benchmark munis, data compiled by Bloomberg show. That spread is down by half from when the bonds priced in September.

With the Federal Reserve saying this week that it plans to keep buying $85 billion of bonds a month to bolster the economy, yields of muni debt, including from California, remain appealing for investors seeking extra income.

Benchmark local bonds due in 30 years yielded about 2.9 percent yesterday, close to the highest since October, data compiled by Bloomberg show. For top earners, that is equivalent to 4.8 percent after taxes. Treasuries of that maturity yielded about 3.2 percent yesterday.

With local interest rates close to a 45-year low set in December, investors have favored longer maturities and lower- rated credits to start 2013.

Bonds rated seven to nine grades below AAA earned 1.3 percent through Jan. 30, the best-performing area by credit quality, according to Barclays Plc data. Securities maturing in 22 years years or later gained 0.8 percent, beating other maturities.

"Everybody's trying to boost their yields," said Hallacy, who's based in New York. "It's especially true in this prolonged low-interest environment."

Following is a pending sale:

ARIZONA HEALTH FACILITIES AUTHORITY is set to issue $280 million of tax-exempt revenue debt on behalf of the Phoenix Children's Hospital as soon as next week, Bloomberg data show.
Proceeds will refund debt sold in 2007 and purchase hospital equipment, according to bond documents. (Added Feb. 1)

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