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Tax-Exempt Market Shrinking for Longest Since 1945: Muni Credit

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By Michelle Kaske

Nov. 26 (Bloomberg) -- The $3.7 trillion municipal market is poised to shrink for a fourth straight year, the longest stretch in almost seven decades, underscoring localities' reluctance to borrow for crumbling infrastructure.

Bondholders are set to receive more in principal and maturity payments this year and next than localities will offer in debt sales, according to estimates from Bank of America Merrill Lynch and Barclays Capital Inc. The market has shrunk every year since peaking at $3.77 trillion in 2010, Federal Reserve data show. Another contraction in 2014 would mean the longest such span in Fed data going back to 1945.

Issuance is ebbing even as revenue is projected to grow for the first time since 2006, according to the National League of Cities. Four years after the longest recession since the 1930s, communities have less appetite to borrow for work on roads and bridges amid concern that the economy may falter again and sap tax receipts, said Phil Fischer, head of muni research at Bank of America in New York.

"I always tell people that every time they hit a pothole, they should roll down their window and tell the guy in the next car that there aren't enough municipal bonds, because that's literally what's happened," Fischer said.

Mitigating Losses

For investors, the decreased supply of securities is helping mitigate losses in 2013, said Fischer and Tom Weyl, head of muni research at Barclays in New York. Detroit's record municipal bankruptcy filing in July has contributed to a decline of about 2.7 percent this year through Nov. 22, the worst performance since 2008, Bank of America data show.

The market for state and local debt totaled $3.72 trillion as of June 30, about 0.2 percent less than three months earlier, Fed data show.

Issuers from California to New York are set to borrow $330 billion this year, $30 billion less than investors will receive in principal and maturity payments, Fischer said. He anticipates the mismatch will repeat in 2014, with bondholders getting back about $25 billion more than anticipated issuance.

Yet the imbalance may only offer municipal bonds a limited boost in 2014, as a growing economy fuels bets that the Fed will curb its monthly bond buying, leading yields higher, Weyl and Fischer said.
Yields on 10-year Treasuries will climb by 0.67 percentage point in a year to 3.4 percent, according to the median forecast of 62 analysts in a Bloomberg survey.

Missing Ingredient

"It's hard to look at that environment and say you've got the ingredients for positive returns in munis next year," Weyl said.

Any increase in yields will attract investors holding cash and looking for a cheaper entry point, said Neil Klein, who helps manage $1.2 billion of fixed income at Carret Asset Management in New York.

"If interest rates did drift higher, you're pulling those investors that have been waiting for that yield level to come back into the market," Klein said.

Since 1989, the municipal market has posted annual losses three times, Bank of America data show. Each time, the market had double-digit gains the following year. Most recently, local debt dropped about 4 percent in 2008, followed by a 14.5 percent rebound in 2009.

Investment Deficit

U.S. cities expect general-fund revenue to grow 0.1 percent in 2013, the first year-over-year increase since 2006, according to an annual survey released last month by the National League of Cities. Yet spending, including on areas such as pensions and health care, will rise 1.5 percent.

"City leaders will likely continue to be cautious about making significant infrastructure investments," according to the report by the Washington-based group.

Infrastructure borrowing through 2020 will fall $1.6 trillion short of needed investment to maintain structures and facilities, according to a March report from the American Society of Civil Engineers.

In the municipal market this week, issuers plan to sell about $544 million of long-term debt with yields at a two-month high. The market is shut Nov. 28 for the Thanksgiving holiday.

Top-rated 10-year munis yield 2.89 percent, compared with 2.73 percent on similar-maturity Treasuries.

Relative View

The ratio of the interest rates, a measure of relative value, is about 106 percent, compared with a five-year average of 102.5 percent. The higher the figure, the cheaper munis are compared with federal securities.

Following is a pending sale:

New York's Dormitory Authority plans to sell $370 million of taxable revenue debt as soon as next week, data compiled by Bloomberg show. Proceeds will allow the state's Workers Compensation Board to acquire unmet obligations of self-insured employers and transfer the claims to third-party insurers, bond documents show. The debt is backed by mandatory assessments paid by most employers in the state, according to Moody's Investors Service, which gives the sale its top grade.