Municipal Update 6/3/16

Munis in the News:

When it comes to coverage of the municipal bond market, the media tends to focus on high profile yet generally isolated situations involving pronounced fiscal recklessness and gross mismanagement. While there certainly are muni credits that fit that profile, most state and local governments continue to exhibit budgetary restraint and economic steadiness, if not strength.

Puerto Rico Spiral:

Puerto Rico's troubles dominate the news, but the Commonwealth's situation has little in common with other public entities in the United States. Puerto Rico began defaulting on its $72 billion in debt over the last several months. Resolution of the crisis remains a moving target. Both parties in Congress are focusing on and, to an extent, actually making a bipartisan effort to reach a solution, but they also differ on some of the key points – such as the power of a potential federal oversight committee and the treatment of various government agency debt. Puerto Rico Governor Alejandro Garcia Padilla has warned of a pending cascade of bond defaults beginning in July unless Congress passes a restructuring. The Governor has stated that his priority will be to provide essential services to the island's citizens.

July 1st is in fact a critical date as the Commonwealth and agencies have over $2 billion coming due – including $805 million of general obligations (GO's). While a likely default is unsettling, it will hardly surprise the market. Much like Detroit back in 2013, Puerto Rico's challenges have been many years in the making. However, the exposure of certain tax-free bond funds to various Puerto Rico credits should be of concern. For years, Puerto Rico bonds were appealing to bond fund managers, given their double-tax exemption and high yields. Puerto Rico issues represent a significant percentage of some tax-free fund holdings. Separate accounts comprised of individual, non-Puerto Rico credits have generally not been impacted by the Commonwealth's travails.

Atlantic City Bust:

On smaller scale, Atlantic City New Jersey barely avoided default on May 1st. The city's budget problems began to intensify as it's lock on casino gambling in the northeast ended years ago. Several casinos have closed since 2014 while others have successfully challenged property taxes, resulting in a 60% drop in AC's tax base since 2010. Significant debt payments are due this month. The state has sued Atlantic City to freeze spending, and the city has countersued – demanding $33 million in aid. This one is a mess, and seems like the worst is yet to come.

Illinois Stalemate:

Speaking of messes, the deadlock in Illinois continues as the state approaches the one-year mark without a budget. As the end of the legislative came and went this past week, a group of legislators sent Illinois' Governor Bruce Rauner a list of budget proposal items that included $8 billion in new taxes and spending cuts, with individual income tax rate moving from 3.75% to a level as high as 4.85%. This would be combined with a broader sales tax that includes services and items currently not taxed. The sales tax increase potentially would provide $5.4 billion in new revenue. Cuts of $2.5 billion would involve shifting some pension costs onto local districts (schools and colleges), as well as reducing health care spending. The Governor has resisted any form of proposed tax increase unless accompanied by structural budgetary reforms, term limits, redistricting, property tax freezes, and changes to collective bargaining with public employee labor unions.

As of this writing, it appears that the best case scenario is a short-term spending bill to fund state operations through the November elections, after which legislators will, in theory, be more amenable to casting difficult votes with less concern about being reelected.

It's Not All Bad!

Away from these discouraging situations, states and cities continue to work their way back to fiscal health. According to Moody's, state tax revenue increased 6% in 2015. State and local tax revenues continue to rise this year, albeit at a slower pace.

Muni credit rating upgrades exceeded downgrades in 2015 for the first time since 2006. Downgrades tended to be concentrated in PR, IL, NJ and PA. Other than PR, there have only been nine municipal defaults in 2016. There were 24 at the same point last year. The situations in PR and AC are very unique and idiosyncratic. Illinois' political struggle and lack of fiscal progress is also exceptional, compared even with its neighboring states. The muni market continues to exhibit strong performance as it distinguishes between the credits highlighted here and those municipalities that are being managed responsibly.

Municipal bond fund inflows remain strong. The week ending 5/25 was the 34th consecutive week of positive investment flow to muni funds, with approximately $26 billion year to date. Fund flows have been positive every month this year, which is the first time that has happened since the late 1990's. Market technicals are strong and getting stronger, with $138 billion in maturities and called bonds this summer. Given that long tax-exempt yields are attractive vs. European and Asian sovereign government bond yields, new overseas buyers are emerging as a factor. Muni ten year yields are 30-50 basis points higher than German and French ten year yields.

Sector Preference:

Revenue bonds are secured by a specific revenue source. They're mainly used to fund income-producing projects. Full faith and credit municipal security doesn't back revenue bonds, but they also tend not to be as vulnerable to local pension issues.

Water and sewer bonds have performed well vs. other muni sectors for more than 10 years. This can be partly attributed to their stable revenues regardless of economic cycles. Water and sewer bonds exhibit below average volatility vs. other muni sub-sectors. Despite the need for infrastructure and maintenance updates, credit fundamentals in the sector continue to improve. Debt service coverage is generally favorable and trending better. Legal structures are strong. Liquidity is more than sufficient – average cash on hand is up about 30% since 2012. There is ample room to raise rates in most systems, should the need arise. Given the dedicated revenue streams, limited exposure to pension liabilities, strengthening operating profits, and prudent cost containment, water and sewer utility issues can provide a good opportunity for portfolio diversification.

Riverbend Capital:

For investors with longer investment horizon, we continue to favor bonds with premium coupon structure for their defensive characteristics. We prefer the intermediate maturity range rather than going out long, given the flatter yield curve. And as credit spreads have tightened, we'd suggest higher quality issues rather than reaching for yield by taking on undue risk.

However, each portfolio is customized according to investor objectives and parameters.

Please feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

Our office has relocated three blocks north. Please note new address:

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