

Localities Beating States as More Pain Brings Gain: Muni Credit

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By Michelle Kaske

Oct. 4 (Bloomberg) -- Debt of U.S. cities and towns is poised to beat state securities for the first time since 2009 as localities' higher yields and efforts to cut workers lure investors in the \$3.7 trillion municipal-bond market.

School districts, counties and cities have been more aggressive than states in cutting employees to lower costs in the past four years following the worst recession since the 1930s. They also tend to have higher bond yields even for similarly rated securities, drawing buyers contending with the lowest interest rates since the 1960s.

Local debt yields 3.1 percent on average, about 0.7 percentage point more than state borrowings, according to Bank of America Merrill Lynch indexes that track each segment and have the same credit grade. City and town debt has earned 6.2 percent this year, compared with 4.9 percent for state bonds, the bank's data show.

"It's just a natural reaction of 'Ok what's left, where can we get some yield?'" said Patrick Morrissey, who helps manage \$2 billion of munis at Great Lakes Advisors in Chicago.

Bond buyers are "starting to look at smaller deals and more things that typically trade much wider."

Still Rebounding

Localities are still recovering from the 18-month recession that ended in 2009 and a housing foreclosure crisis that sapped property-tax collections. Since peak levels in 2008, local municipalities have reduced payrolls by a combined 549,000 workers, or 3.8 percent, data compiled by Bloomberg show. That compares with a drop of 167,000, or 3.2 percent, for states.

While states can balance their budgets by cutting aid to localities and school districts or delaying payments, cities and towns must operate with the revenue they have, said Neil Klein, who helps manage \$1.2 billion of fixed income at Carret Asset Management in New York.

California's Governor Jerry Brown this year scrapped about 400 municipal redevelopment agencies and redirected their tax funds to help balance the state budget.

Local municipalities "do have to find ways at the ground level to make their finances work," Klein said.

Risk Factor

City and town debt does carry greater risk than state borrowings, Morrissey and Klein said.

In California, three municipalities have filed for bankruptcy protection since June. States may cut local aid further to help absorb potential federal-spending reductions that are set to start in January unless Congress acts.

With California local debt, "there's a guilty-by- association impact," said Burt Mulford, a portfolio manager in St. Petersburg, Florida, at Eagle Asset Management Inc. Among California localities, Eagle opts for those with per capita income that is above average, such as Beverly Hills, he said.

Mulford spoke yesterday at the State & Municipal Finance conference hosted by Bloomberg Link in New York.

Yields on tax-exempt debt have dropped this year as investors sought a haven from Europe's debt crisis. Yields on general obligations due in 20 years and rated Aa2, Moody's Investors Service's third-highest grade, were 3.67 percent Sept. 27, according to a Bond Buyer index. The index touched 3.60 percent in January, the lowest level since 1967.

'Huge' Boost

As a result, investors have sought out lower-rated credits for their additional yield. A local-government borrowing can sometimes yield as much as 40 basis points more than other debt sales, Morrissey said. A basis point is 0.01 percentage point.

"A 30 or 40 basis-point pickup relative to the rest of the market is huge," Morrissey said.

In one example, Hamden, Connecticut, located about 85 miles (137 kilometers) from New York City with a population of about 60,000, sold \$24.7 million of tax-exempt, general-obligation debt in August.

Debt maturing in 10 years and rated A2, Moody's sixth-highest level, priced to yield 3.01 percent, data compiled by Bloomberg show. On Sept. 21, Connecticut, rated two grades higher, issued 10-year general obligations with a yield of 2.09 percent.

In a boost to local debt, property-tax revenue, a major revenue source for cities and towns, may be improving.

Local governments' property-tax collections increased 6.2 percent in the second quarter from the same period last year, U.S. Census data show. U.S. home prices in July climbed 1.2 percent from the same month in 2011, the most since August 2010, according to the S&P/Case-Shiller index of property values in 20 cities.

In muni trading yesterday, the yield on 10-year AAAs fell 0.02 percentage point to 1.67 percent, the lowest since Aug. 1. It touched 1.63 percent July 27, the lowest since at least January 2009, data compiled by Bloomberg show.

Following are pending sales:

CITY AND COUNTY OF HONOLULU plans to offer \$925 million of tax-exempt debt as soon as this month, data compiled by Bloomberg show. (Added Oct. 4)

GUAM POWER AUTHORITY is set to sell \$354 million of revenue bonds as soon as today, data compiled by Bloomberg show. The sale will refund debt and will be enhanced with bond insurance, according to offering documents. (Updated Oct. 4)

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