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Municipal-Bond Offers, Costs May Be Cut by Obama's Stimulus

By Darrell Preston

Feb. 13 (Bloomberg) -- The U.S. federal government's $789 billion plan may allow state and local governments to reduce borrowing as much as 8 percent while providing lower interest costs for new municipal issues coming to market.

Bond sales may fall as much as $30 billion, said Guy LaBas, fixed-income strategist with Janney Montgomery Scott, a financial advisory firm based in Philadelphia. State and local borrowers sold $386.5 billion of debt in 2008, 9 percent less than in 2007, a record year, according to data compiled by Thomson Reuters.

A smaller supply of municipal bonds may raise prices and cut borrowing costs for state and local governments, said Richard Ciccarone, managing director of Oak Grove, Illinois- based McDonnell Investment Management, which manages $11.1 billion. Top-rated municipal borrowers of 10-year maturities paid interest rates of 3.28 percent on Feb. 12, according to Municipal Market Advisors data, down from one-year a high of 4.71 percent Oct. 16.

"The governments are so hard-pressed they just want to use the federal money to cover their losses" in revenue, Ciccarone said. "From their standpoint, less issuance should help them get a better deal on the money they do borrow."

State officials have whittled the deficit they face this fiscal year to $47.4 billion from $87.7 billion originally projected, according to the Denver-based National Conference of State Legislatures. California alone anticipates a $42 billion shortfall through June 2010. The national shortfall is due to reach $84.3 billion next year, the legislatures group said.

Stopping the Bleeding

Two-thirds of municipalities surveyed by the National League of Cities last year said they were less able to meet fiscal needs than in 2007.

"You need to stop the bleeding first," Ciccarone said. "To do that, you shift the cost to the federal government, which would be a huge help to state governments."

Even before the federal economic plan was unveiled, municipal bond issuance was projected to drop more than 6 percent to about $364 billion, the least since 2004, based on an average of estimates from London-based Barclays Plc, Loop Capital Markets LLC. in Chicago and Bank of America's New York- based Merrill Lynch & Co.

In October, as the seizure in the credit markets made investors hesitant, yields for municipal bonds rose to an eight- year high of 6.01 percent from a low last year of 4.15 percent, reached in January. Yields exceeded Treasuries, peaking on Dec. 18 at more than 2 percentage points. Traditionally, municipals paid less than Treasuries because investors benefited from a tax exemption on their dividends.

Municipal Yields

The prospect of the stimulus legislation under President Barack Obama has helped narrow the difference, or spread, between municipal bonds and U.S. Treasury securities to 0.49 percentage points Feb. 12 from 2.02 percentage points Dec. 18.

The compromise stimulus package provides about $224 billion to states, including $87 billion to help with the cost of Medicaid, health insurance to the poor; $53.6 billion for education, and $63.4 billion for infrastructure, including roads and bridges, transit and high-speed rail systems and clean water, according to data from U.S. House Speaker Nancy Pelosi, posted on the Web site of the National Conference of State Legislatures.

As the credit market freeze lengthened following the collapse of Lehman Brothers Holdings Inc. on Sept. 15, some municipal borrowers struggled to sell bonds. California, shut out of the municipal bond market as it ran out of cash amid a record deficit, is considering selling infrastructure bonds to the Bay Area Toll Authority, which operates bridges in the San Francisco area.

States' Creditworthiness

The stimulus package "may help the creditworthiness of the states because it would supply operating cash," said Bill Walsh, president of Parsippany, New Jersey-based Hennion & Walsh Asset Management, a municipal bond trading firm that manages about $151 million. "This would enable the states to close their short-term budget gaps" and support existing creditworthiness, he said.

Standard & Poor's cut California's rating on $46 billion of debt to A from A+ on Feb. 2, making it the lowest-rated state behind Louisiana. In January, S&P changed Florida's AAA outlook to "negative" as falling sales-tax revenue contributed to a budget deficit. Illinois received a "negative" outlook in December.

Besides substituting the Treasury financing for their own, some governors plan to use part of the money to balance budgets or fund projects that couldn't begin as credit dried up. Southampton County, Virginia, which sold $32 million of municipal bonds in October for sewer system improvements, wants to use stimulus funds to repay the debt and avoid raising taxes.

Prepaying Debt

“Prepaying debt service will have a significant impact on our taxpayers,” said Michael Johnson, Southampton County’s administrator. “Mitigating the effect on taxpayers would stimulate our local economy.”

Ohio Governor Ted Strickland, a first-term Democrat, said on Jan. 28 he would use an estimated $3.4 billion of stimulus funds to help close a $7.3 billion deficit. Minnesota’s second- term Republican governor Tim Pawlenty proposed using federal aid to help cut his state’s projected $4.8 billion shortfall for 2010-2011.

U.S. voters approved issuing $74.6 billion of new municipal bonds last year, according to Ipreo and the Bond Buyer newspaper.

State Appropriations

States “want to appropriate that money even though they don’t have it yet,” said Michelle Blackston, spokeswoman in the Washington office of the legislators’ group. “A lot of projects have been stalled or postponed because they don’t have the money.”

The SouthField project in Massachusetts envisions 2,855 housing units, 2 million square feet of commercial development and a public golf course at the site of the former South Weymouth Air Station, south of Boston.

Local officials’ attempts to sell unrated municipal bonds to fund $40 million of roads, water lines, sewers and a wastewater treatment plant failed last year, said Eric Kfoury, interim executive director of the South Shore Tri-Town Development Corp., a redevelopment agency on the project.

“Now, we see a chance to do something that will create construction jobs and keep this redevelopment on pace,” Khoury said.

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