



Is the Local Muni Future Global?



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A quarter century ago, Jonathan Walters, a great observer of state and local government, said, “...counties have become the backstop of American government. In fact, a huge amount of responsibility for some of society’s toughest, costliest, most thankless jobs has either been handed or simply devolved to county governments, and the results can be overwhelming.”

Not long ago, a CFO from a medium-sized city in the Midwest told me an intriguing story. She was getting ready to close on a general obligation bond sale. Toward the end of the process, her municipal advisor suggested she spend a few thousand extra dollars to have the bond prospectus translated into French and Japanese. When she asked why, the muni advisor said, “You’ll save a lot of money if buyers in Brussels and Tokyo can learn about you quickly.” This answer tells us a lot about today’s municipal bond market.

Bonds sold by U.S. states and localities are special for a few reasons. For one, they trade in a market unlike any other. Few other countries in the world have devolved as much autonomy to

sub-sovereign entities as the United States. This autonomy allows states and localities to levy taxes and borrow money in ways that governors and mayors in other countries can only imagine. Another, of course, is the tax exemption. Investors don’t pay federal or (usually) state income taxes on the interest earned from holding municipal bonds (munis).

These two features make the muni market highly localized. These bonds make perfect sense for individuals who want a safe way to save for retirement and want the additional tax benefits, on top of a chance to invest in projects in their community. This is especially true for high-net-worth individuals in high-income tax states like California and New York, so it’s no surprise that mutual funds and other money managers have developed a variety of state-specific investment funds. Munis also make sense for insurance companies looking to match their long-term liability exposures with local assets. In fact, it’s often said there is no “municipal bond market,” but rather 50 local muni markets.

Given that, it seems odd that munis would attract any attention from

international investors. After all, they can't realize the tax benefits if they don't have U.S. income tax liability. And if they don't know the local community, why would they care to invest in it?

But it turns out that international investors are a growing share of the muni market. In fact, according to the Federal Reserve, they've grown from less than 0.01 percent of muni bond holders at the end of 2010 to more than three percent at the end of 2020. That's about \$100 billion of munis in foreign hands. What's driving this trend, and why should state and local bond issuers care? Three interrelated reasons come to mind.

One big reason is today's ultra-low interest rate environment. Yields on U.S. Treasury bonds and corporate bonds have sat at record low levels for several years now, with no indication that they'll increase any time soon. This has motivated many investors who don't normally benefit from the tax exemption, including many international buyers, to poke around in the muni market for high yields with minimal additional credit risk. This has contributed to lower interest rates across the muni market generally.

This unique interest rate environment has also created a unique borrowing opportunity. With rates and credit spreads so low, state and localities can offer up taxable munis that appeal to these taxable buyers. If this appeal is strong enough, yields on those taxable bonds might be as low or even lower than yields on an equivalent tax-exempt offering.

This is especially true for issuers that pay off old bonds ahead of schedule at lower interest rates, a practice known as advanced refunding. The federal Tax Cuts and Jobs Act of 2017 outlawed tax-exempt refundings, mostly as a way to capture some additional federal revenue to fund the tax cuts it included. But it did not outlaw taxable advanced refundings. Moreover, low taxable rates open the door to projects that don't always

qualify for the tax exemption because they benefit private interests as well as taxpayers, like airport upgrades and convention center expansions. All this said, it's no surprise that taxable muni issuance in some sectors was up more than 60 percent in 2020, and we expect to see even more in 2021. International investors are in the center of that action.

International investors are also shaping the muni market because they've helped establish munis as an alternative to Treasury bonds. As debt-financed COVID-related spending continues to weaken the federal government's balance

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sheet, investors will look to munis as an alternative safe fixed-income asset. As spending needs grow but willingness to pay taxes stays flat, Americans will have to choose between a federal government that mostly takes care of the elderly and pays interest on bonds from 30 years ago, or a local government that gives them clean water, electricity, and working toilets. Many foreign investors are betting they'll choose the latter. If this is true, then yield spreads between Treasury bonds and munis will remain low for the foreseeable future.

A third emerging trend is munis as green bonds. The Climate Bonds Initiative (CBI) defines green bonds

as infrastructure investment that supports the transition to a carbon-neutral economy. This includes everything from clean energy production capacity like solar and wind, to public transit systems, to new seawalls and stormwater management systems, to LEED-certified public buildings, and many other projects. The connection to the muni market is obvious. In fact, some say that munis are the "original green bond."

CBI estimates that about \$45 trillion is controlled by asset managers who have pledged to allocate some portion of their portfolios to green bonds. This suggests the market for green bonds is immense. Perhaps not surprisingly, much of that pledge is from national and sub-national public pension funds like Canada's Ontario Teachers' Pension Plan and Japan's Government Pension Investment Fund.

It's not surprising, then, that everyone from the State of California to the Washington, D.C., water system has sold green bonds. While not all green bonds represent new investment activity, some may represent existing opportunities repackaged as green bonds. It's also worth noting that a recent paper by David Larcker and Edward Watts shows that the demand for green bonds has yet to translate into lower borrowing costs for governments that issue them. But that demand will continue to grow, and much of it will come from foreign investors.

With these trends in mind, an official statement in French or Japanese makes some sense. Going forward, state and local issuers should keep in mind that the future of local munis may, in fact, be global. ■

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