



PERSPECTIVE

Twos Are the New Fives

BY JUSTIN MARLOWE



There's a subtle but seismic shift happening in the municipal bond market. States and localities should be aware of it and its consequences.

First, a quick “bond math” refresher. Let's say a city issues a ten-year \$5,000 municipal bond with a semi-annual 2.5 percent coupon. This bond requires the city to make interest payments of \$62.50 twice a year, and then pay back the \$5,000 at the end of year ten. If an investor buys that bond for 100 percent of its face value, or at “par,” they will receive those coupon payments and the \$5,000 when the bond matures. They could also pay more than 100 percent—a “premium”—if they think the bond is a particularly attractive investment or pay less than 100 percent—buy it at a

“discount”—if it's less attractive. Keep in mind that most municipal bond coupon payments are exempt from federal income taxes and often from state and local income taxes.

When issuers set coupons on their bonds they go through a “Goldilocks” exercise. A bond that sells at a high premium suggests the issuer could have raised the same amount of money but with less debt service. Extreme premiums are also unattractive to some investors because they don't produce noticeable cash inflows until close to the bond's maturity. By contrast, if the bond sells at a discount, the issuer might not raise all the money it needs. Discount bonds also have unique tax implications—for example, the “de minimis” rule—that makes them

unattractive for many issuers. For these reasons, an issuer's goal is to sell the bonds at a slight premium. That suggests the coupons were, just like Goldilocks' porridge, not too hot and not too cold.

For more than a decade, five percent, known as "fives," was the Goldilocks coupon rate. Fives were considerably higher than the taxable equivalent coupons on U.S. Treasuries and corporate bonds. This made them appealing to big institutional investors like mutual funds, which liked their value relative to other potential bond investments. High coupons also appeal to individual investors who care about future cash flow. In an environment where interest rates and income tax rates are both expected to rise, as has been the case for about the last decade, it helps to have more tax-free cash flow from coupons to reinvest at higher interest rates later. Fives did that trick without pricing at too high a premium.

Fives also worked for issuers' long-term debt management plans. Many state and local debt managers have professed that "fives always save a lot of interest." This is because they've tended to price at such large premiums that refinancing later, even at higher market interest rates, would still produce premium pricing. This flexibility is invaluable to government debt managers. Consider also that premium bonds generate more money to invest in projects. If an issuer expects to raise a million dollars with a bond, but the bond prices at 110 percent, then they've actually raised \$1.1 million. That's why it's no surprise that more than half of all new-issue munis with maturities of longer than eight years were fives, and most of the major municipal bond market indices are derived from the prices and yields of fives.

Now it seems the golden era of fives is over. To illustrate, let's compare

trends in coupons on new-issue munis during two time periods: January to June 2019 and January to June 2021. According to data from Ipreo, 34 percent of all new ten-year maturities in the first half of 2019 were fives, while fours and threes comprised 18 percent and 23 percent, respectively. By the first half of 2021, fives were only 17 percent of new issues, and fours and threes were both 17 percent. In fact, twos were the new leading category, at 21 percent of new issuance.

As expected, lower coupons have also meant lower prices. In the first half of 2019 the median price on a new ten-year maturity was 111.53 percent. In the first half of 2021, this median price had dropped to 106.33 percent. Keep in mind also that the share of new munis issued with default insurance held steady at about 23 percent across these two time periods. There's also no evidence that issuers are selling bonds with shorter call periods. About 35 percent sold with ten-year calls across both periods, along with nine- and eight-year calls at about 18 percent of total issuance, each. In other words, these changes in prices are due in large part to lower coupons.

So, what does the demise of fives mean for future state and local debt management? Two key considerations come to mind right away.

One is that lower coupons open the door to creative uses of taxable munis. In the first half of 2019, less than five percent of all new issue ten-year bonds were taxable. In the first half of 2021 it was just short of 18 percent. Much of this surge was for taxable refundings. When rates are low overall, and the spread between taxable and tax-exempt rates narrows, then the tax advantage of tax-exempt munis erodes quickly. At the same time, investors that don't benefit from the tax exemption can buy taxable

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munis and take down a much better rate of return than Treasuries or corporates. As long as low rates, tight spreads, and lower muni coupons persist, taxable issuance has real advantages.

A second implication is that the era of easy refunding might also have come to an end. With interest rates and tax rates expected to rise, issuers can no longer count on guaranteed savings from refundings. "Scoop and toss" refundings that save money by extending the maturity of existing debt will become much more difficult to execute. High premiums on new issues, often used to finance smaller maintenance and other projects at the margin, will become scarcer. Debt managers hoping to squeeze out a few additional dollars for capital projects by shaving off a few basis points on the next debt issue might be a thing of the past.

Issuers should start planning now for a world where twos are the new fives. ■

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