Municipal Bond Sales:
Light at the End of the Tunnel?

By Carol Samuels, Seattle-Northwest Securities

If we had written this article two weeks earlier, we would have had a very different tone and outlook, as long-term municipal interest rates were at that time approaching six percent—rates not seen in nearly a decade, and even then, only briefly.

On the other hand, we are writing this after an extremely successful sale of $50 million in General Obligation Bonds for Chemeketa Community College, where the all-in yield was at 4.95 percent. Chemeketa's bond sale, initially scheduled for September 30, was postponed as rates climbed as high as 5.80 percent. In the market generally, **long-term rates have dropped back down by about 80 basis points**, after increasing by nearly 150 basis points (1.50 percent) since September 10. The Chemeketa sale was met with exceptionally strong demand—in fact, demand for bonds well exceeded the available supply.

Will this be the same story next week? Hard to say, but the municipal market does seem to be returning to some semblance of rationality after several weeks of unpredictable and arguably unjustifiable gyrations. In recent weeks, the State of Oregon and the city of Portland also successfully sold bond issues. And although current interest rates are somewhat higher than would have been the case in recent months, they have been coming down steadily and are lower on a historical basis than those experienced over the past two decades.

What's going on? Clearly, the municipal market has been afflicted by some of the same conditions affecting the market generally. Prior to mid-October, municipalities had essentially been shut out of the market, causing major infrastructure projects to be put on hold across the country. The huge dislocations in the stock market had led to a "flight to quality" that had benefitted one market alone: the market for Treasury securities. Thus, as Treasury yields were hitting all time lows, municipal rates were climbing dramatically.

This not only made no sense from a credit quality perspective—the rate of default on municipal bonds is miniscule—but it makes no economic sense, as interest earned on Treasury investments is taxable, whereas most municipal investments are tax exempt. At one point, the dislocation between these two markets resulted in taxable Treasury rates that were over a full percent LOWER than municipal rates of the same maturity.

However, it appears that investors are starting to remember why they choose to purchase tax-exempt bonds in the first place: safety of principle, assured income stream and tax-exemption. These facts have not changed in the recent credit crisis.

Other indications that the municipal market is beginning to return to a more "normal" condition include:

1. **Improvement in the short-term variable rate market.** Though few Oregon municipalities borrow in the short-term market, it is an indicator of overall credit market health. Companies that invest in municipal bonds also borrow in the short-term market. When their ability to borrow is constrained, those investors must reserve capital for more immediate needs. The significantly higher short-term rates have moderated recently and are returning to historical norms.
2. **Increase in long-term fixed-rate issuance volume.** The middle two weeks in October were marked by a virtual credit market freeze. Issuers that want or need to borrow had been hampered by a lack of investor demand. The normal weekly supply of new issue municipal bonds ranges from $3-$5 billion. The current visible supply of municipal bonds stands at approximately $2 billion, and there is an estimated $13 billion of "invisible" supply of municipal bonds that has been postponed as a result of market conditions. During the week of October 20, we saw several high-quality municipal transactions successfully price. This is an improvement over the prior week. Greater issuance volume is sign of increased investor demand and overall market health.
3. **Improvement in tax-exempt municipal yields compared with taxable Treasury yields.** The current credit crisis resulted in unprecedented market dislocation between the market for taxable U.S. Treasury securities and tax-exempt municipal securities. Normally, 20-year tax-exempt bond yields would trade in a range of 85 percent to 95 percent of 20-year Treasury bond yields. The dislocation between the tax-exempt and taxable markets was most dramatic on October 15, when 20-year tax-exempt bonds traded at 126 percent of equivalent term taxable Treasuries. The dislocation is due to an extraordinary flight to quality by all investors including municipal investors with quality represented exclusively by U.S. Treasury bonds. Since October 15, falling tax-exempt municipal bond yields have improved the relationship to taxable Treasuries. As of October 24 the relationship between 20-year tax-exempt bonds and taxable Treasuries had fallen to 114 percent. This move towards normalization of these trading ratios is indicative of investors returning to the municipal bond market.

What should I do as a financial manager if my municipality is thinking about selling bonds?

1. Market participants are very credit sensitive and are specifically looking for strong credits like property tax supported general obligation bonds, general fund backed full faith and credit obligations and highly rated essential governmental services like utility enterprise systems. Underlying ratings are increasingly important.
2. Rating downgrades of municipal bond insurers mean there is currently little or no value in obtaining bond insurance. For a school district or community college, the availability of the Oregon School Bond Guaranty is extremely helpful.
3. Issuers should create as much flexibility as possible in terms of planning the structure and the timing of a bond sale.
4. The current market is dominated by retail investors. In structuring your issue, however, it's important to understand a couple of aspects about this sector.

   First, when underwriters refer to retail investors, they are not simply referring to individual investors. In addition to individual investors "retail" also includes money managers (investment advisors), trust departments, and high net worth investors. Because all of these components are important to overall retail participation, it is important not to focus exclusively on individuals to the detriment of other retail sectors.

   Second, general obligation bond issuers should be particularly aware that retail as a whole prefers to purchase discount bonds. Discount bonds are sold for an amount less than their face or par value and accrue to face value at maturity. This results in less proceeds available for projects because the voter authorization is for the face or par amount of bonds sold.
5. If you need to access the market quickly, work closely with your financing team to carefully structure and time your sale. There are investors eager to obtain the high-quality tax-exempt issues for which Oregon is well regarded. With the right combination of structure, security and advance planning, your issue will be well received.

In summary, we expect that the high quality bonds that Oregon municipalities typically offer will continue to be in strong demand in this economic environment. Issuers, however, should anticipate that the planning and execution of a transaction might take longer than had previously been the case and may come at somewhat higher costs. With careful structuring, however, your municipality should be able to successfully navigate these waters and produce favorable results.

Editor's Note – Carol Samuels is a Senior Vice President at Seattle-Northwest Securities. For more information contact her at (503) 275-8301. ■