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Pension fears cloud US municipal debt market

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US investors know in a crunch politicians favour voters and pensioners over bondholders

Three large US pension schemes have laid out aggressive plans to drive down investment costs

On the Boardwalk in Atlantic City, just across from the hot dog stands and thrill rides on the old Steel Pier, sits the Trump Taj Mahal. Opened in 1990, it went bust a year later. Two other casinos carrying the name of Donald Trump went the same way over the following years. The Taj — which failed again in 2014 — was sold last week to Carl Icahn after emerging from bankruptcy protection.

But Mr Trump — the frontrunner in the race for the Republicans' pick for president — is not the only one to have struggled in this rundown gambling resort in the south of New Jersey. The city itself is on the verge of running out of money, laid low by years of duff investments, plunging property tax receipts and competition from a new crop of casinos across the north-east.

Serious trouble could still be averted. State governor Chris Christie — now a potential running mate for Mr Trump — could come up with a rescue package acceptable to the city before April, which is when cash flows turn negative, on Standard & Poor's projections. But in the meantime, the fate of the city's debt is weighing on America's $3.7tn municipal bond market. Investors know that when it comes to the crunch, pensioners tend to do better than bondholders.

That was the case in Detroit, the biggest ever collapse three years ago, which inflicted losses on holders of its "general obligation" bonds. Such instruments are not attached to any particular stream of revenue but were nonetheless thought to be rock-solid, as they are backed by a full faith and credit pledge and the unlimited taxing authority of the city. Even so, investors in Detroit's GO bonds took big hits as the city restructured its balance sheet — just as investors in other classes of bond did after the bankruptcies of Stockton, Vallejo and San Bernardino, all within the past few years.

The threat of more battles between retirees and bondholders is bothering Peter Hayes, who oversees $110bn of state and local debt as the head of the municipal bond group at BlackRock, the world's biggest asset manager. Everyone is anxiously eyeing Chicago's $20bn unfunded pension liability — in particular, he says, conscious of the mismatch between the short horizon of the typical term of political office and the very long horizon of pension obligations. Time and again, politicians have shown that they'd rather protect voters than investors.

Detroit "set a fairly dangerous precedent" for GO bondholders, he says. "Politics seemed to trump the rule of law."

Some lobby groups are urging authorities to cut pensions benefits, as persistently low interest rates increase the present value of their future burdens. In Philadelphia, for example, a watchdog has urged the mayor, the city council, the pensions board and union groups to combine to put its $4.8bn pension fund on a firmer footing.

What credit rating agencies want to see from all municipalities is some kind of plan, says Jane Ridley, a senior director in the US public finance team at S&P in New York. It does not particularly matter what the plan looks like, or what kind of assumptions authorities are using. But a plan gives some comfort that they are not simply hoping that the problem goes away.

"Are they aware of it?" she asks. "What do the rising costs look like? What would they need to address over time to meet their obligations?"

Munis remain a haven, amid choppy fixed-income markets. There are still 336 triple-A American municipalities, on S&P's count, from Acton Town in Massachusetts to Yorba Linda, California — all

with solid economies, tight budgets, stable institutions and good liquidity. This week investors digested about $12bn of new issuance across the market, an unusually high amount, without much drama.

Even Chicago is still selling debt at reasonable rates. In January the city sold $500m of GO bonds with a 5 per cent coupon, yielding 229 basis points more than the benchmark rate for the best-rated borrowers. That was less than a 252 bps spread in a similar sale last July, shortly after Moody's had downgraded the city's credit rating to junk.

But a triple-C borrower like Atlantic City — which was rated single-A until 2012 — is a reminder of how quickly things can turn.

And when they do, investors are unlikely to emerge with the swagger of a Mr Trump.

"Stop saying I went bankrupt," he tweeted last June. "I never went bankrupt but like many great business people have used the laws to corporate advantage — smart!"

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