Muni pros advise digging deep for value amid Puerto Rico, Chicago panic —Conference Coverage
By Gunjan Banerji
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As municipalities facing immediate financial crises dominate the bond market's narrative, digging deep to uncover credits harmed— but not fundamentally impacted—by contagion risk is where investors can reap value, agreed panelists at the Munis: Chicago, Detroit, Puerto Rico and More conference in New York today.

Participants noted that credits like Puerto Rico, Detroit, and Chicago affect how the market approaches other municipal investments, but stressed the importance of not discounting investments marred by proximity to perceived danger. While certain credits face immediate risk and are running out of time, the municipal market at large remains high-quality, they said at the conference hosted by the Global Interdependence Center.

Meanwhile, as the market continues to gain clarity on the fundamental issues plaguing certain cities, the timeline from when a municipality enters the "point of no return"— where it's clearly not a viability entity and has an unsustainable amount of debt— and the point where it defaults is shrinking, the panelists said.

For example, Detroit hit a "point of no return" 30 years ago, while the financial markets became keenly aware of the Motor City's problems just in the past few years, said Tom Tzitzouris, a director at Strategas Research Partners, speaking on a panel titled "City Credit Review." For Puerto Rico, that same timeline was shortened by about a dozen years, and it should continue to contract for subsequent distressed municipalities, Tzitzouris continued.

Opportunity calling

As pension expenditures crowd out other municipal expenditures, "it won't result in a pension crisis, it will result in a city crisis," Tzitzouris went on. How cities deal with the crowding-out effect matters, as it can lead to urban blight, declining property prices, inflated tax, and deteriorating city services, he noted.

This can precipitate a vicious cycle of high debt and crime load that cities can't shake, eventually leading to a point of no return such as Detroit's, Tzitzouris said. Pension risk does not transfer from one struggling municipality to an adjacent one, he noted. However, high crime rates can become your neighbor's problem.

But poorly funded state funds don't equate to poorly funded local funds, said Natalie Cohen, a managing director at Wells Fargo Securities, speaking on the same panel. This can mean value for investors who are willing to do their research.

Today's municipal market lends itself to finding diamonds in the rough, the participants agreed. There are many plans funded above 90%-- investors should find investment opportunities within the state and local governments that have exercised funding discipline, Cohen continued. Investors can find quality locals within states that have suffered from poorly funded pensions, such as Illinois, Connecticut, Pennsylvania, and New Jersey, Cohen said.

The market is pricing in sensitivity from Puerto Rico credits. The commonwealth's debt crisis has ushered in a new era of municipal investing, in which bondholders must prepare for headline risk, deteriorating credit quality, and the social implications of it all. But the contagion creates buying opportunity, Tzitzouris added.

"The muni market is a sentiment-driven market," commented Michael Comes, vice president of research and portfolio manager at Cumberland Advisors, on a panel titled "Puerto Rico Update."

Illinois and Chicago are outliers, Cohen noted. Chicago, Cook County, and downstate credits are at risk, but the Illinois Municipal Retirement Fund is well-funded, and has 652 employers within the state as members, she noted. It's possible to find interesting investments in stable, decent communities with well-funded pensions, Cohen said.

Problem children remain

Puerto Rico's pension is pay-as-you-go at this point, and has evaded analyst and media attention for the most part, Cohen said. Kentucky also has serious pension problems.

"Chicago is running out of time," Tzitzouris said. The city is hit with a double-whammy, in that both it and the state of Illinois are facing the same squeeze, he noted. This gives it less of an opportunity to rely on the state for a transfer of payments to deal with its crisis.

While the Windy City is well-positioned to withstand further cash flow needs from a per capita wealth and tax base standpoint, Chicago is very close to being downgraded a second time into junk within the next month, which could accelerate its time line, Tzitzouris said.

Puerto Rico's restructuring and a second downgrade of Chicago could create capital flight from the system, Tzitzouris said. Other cities such as Philadelphia and Memphis also face deep fiscal issues, he added.