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Window for cheap borrowing is closing

by Jennifer Bissell

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Municipal bonds are a vital way state and municipal entities finance infrastructure improvement projects related to roads, bridges, schools and more.

And while borrowers have enjoyed low interest rates on bond financing during the economic recovery, the days of cheap borrowing are slowing coming to a close. Just as the economy is starting to pick up, so too are bond interest rates.

The Fairfield County Business Journal recently asked Peter Chieco, a senior vice president of Morgan Stanley Wealth Management, to explain what the rising interest rates mean for investors, municipalities and taxpayers.

Peter Chieco of Morgan Stanley Wealth Management

FCBJ: Interest rates everywhere are increasing, including the municipal bond market. What does this mean for state and local governments in Connecticut?

Peter Chieco: “When interest rates increase, the price of bonds tends to decline. This can be good for buyers of bonds, but for issuers of bonds, like the state of Connecticut and local governments, higher interest rates can increase borrowing costs. The short-term impact is somewhat muted though, since most of the current debt outstanding is already locked in at low interest rates for a number of years. The real impact is primarily on new borrowing and refinancing. Given the still very low interest rate climate, the recent rise in interest rates is worth monitoring, but likely to have little impact on municipality funding costs. A much larger and sustained increase in interest rates would be more worrisome.”

What’s driving interest rates?

“Interest rates are primarily driven by the outlook for the economy. As an example, a stronger economy is usually accompanied by rising interest rates. We are however in a very interesting period in our country’s history. While Federal Reserve policy has frequently lowered short-term interest rates in the past to stimulate the economy, Chairman Bernanke also has embarked on quantitative easing, which is unprecedented. Quantitative easing is the action of the Federal Reserve to purchase longer term bonds to keep interest rates low. This is the first time in history that the fed is directly stimulating the whole interest rate yield curve. The recent decline in bond prices is the result of the fed alerting the markets to their eventual end of quantitative easing.”

Have you seen a lot of activity in municipal bond trading lately?

“During the month of June in particular, trading activity for all bonds, including municipal bonds, was very elevated. If we look at the absolute level of interest rates on very high quality municipal bonds and compare them to U.S. Treasury bonds, municipal bonds pay a higher rate of interest and are usually tax free. This creates an additional incentive for nontraditional buyers of tax free bonds to enter the market. In other words, hedge funds and pensions purchased tax free, in addition to the traditional core of individual buyers. Many of these nontraditional buyers sold down their holdings last month, raising the trading volume. Individual investors were generally not sellers last month. The rising rates though will impact their portfolio values as their bonds will have declined in price.”

What does this mean for taxpayers and the state’s economy?

“The state’s overall economic health is the ultimate driver of the need and use of municipal bond financing. The lowering of interest rates over the past four years has allowed for a reduction in financing costs, as old bonds were refinanced and new bonds were issued. This helped cushion the recession’s decline in income tax and real estate revenue to the state. As the economy improves, municipalities should be able to benefit from increased revenue and lower borrowing costs for a number of years. Generally speaking the burden on taxpayers could lessen, but we must remember that Connecticut has a high debt load.”