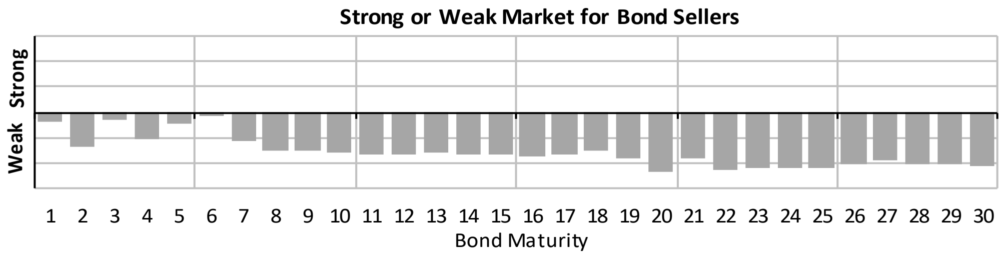
MMA Independent and Data Driven

HilltopSecurities
A Hilltop Holdings Company.

MUNICIPAL MARKET JOURNAL



MMA 5% AAA Benchmark

	7/7/2017	*6/30/2017*	*Change*
2-yr	1.05%	1.05%	0
5-yr	1.48%	1.45%	3
10-yr	2.18%	2.15%	3
30-yr	3.00%	2.97%	3

Last weeks losses have continued to push the municipal curve cheaper and, particularly in longer maturities, prices to "oversold" levels. This means that, outside of the 1, 3, 5 and 6-year spots, buyers should be able to find better value opportunities and issuers are facing a more concessionary pricing environment vs. last week.

MARKET UPDATE

The downtrend in bond prices may or may not be sustainable, but municipal yields will likely only rise grudgingly given the relative steady demand and overall light supply (despite this week's calendar).

HIGHLIGHTS

- Bond yields rose last week as investors, now worried about a near-term end to ECB accommodation programs, continued to retreat from the strong price gains of the 1H17 bond rally.
- A relatively strong June jobs reading on Friday was another piece of data that was unfriendly to bond yields/prices. Since the November elections municipal prices have steadily responded less favorably to employment data.
- US Treasuries, which had appreciated and flattened most aggressively, experiencing a bear steepening (i.e. higher yields along a steeper curve) by 7 bps as the 30yr bond yield rose 9 bps (**Figure 1**).
- Holiday week inactivity, along with a still-pressing supply/ reinvestment problem (i.e. limited investment product available vs. ample product demand), dulled municipals' negative response; **MMA**'s AAA municipal benchmark curve weakened a uniform 3 bps.
- Consequently, municipal/US Treasury yield ratios plunged, the 10-year ratio hitting a YTD low (91.3%) on Thursday. The 2 and 5-year ratios have declined to levels that are lower than the averages attained between 1999 and 2007. Non-traditional buyer demand for municipals is likely to be dampened by the low ratios.
- This ratio disadvantage will force underwriters to widen price concessions for this week's $9B+ primary market calendar. In addition secondary bid/ask liquidity is apt to worsen and blur statement valuations. **MMA**'s value index now favors investors, NOT issuers.
- Although Lipper showed a modest outflow last week, and recent fund NAV declines (high grades down almost 1% in the last month, high yields 1.5x that—**Figure 3**), funds may well all be sitting on sufficient cash to pay departing investors. Thus far forced secondary selling has not emerged, which if it should, would roil markets.
- The market has also just begun to realize the opportunity in Illinois GO bonds, which rallied 80+ bps last week (**Figure 2**) despite a new threat of downgrade by Moody's. Chicago/CPS bonds rallied as well but less so –indicative of the persistent demand for yield by investors which has enable the market's riskiest credits access to capital in a magnitude similar to the 2003 and 2007 period.

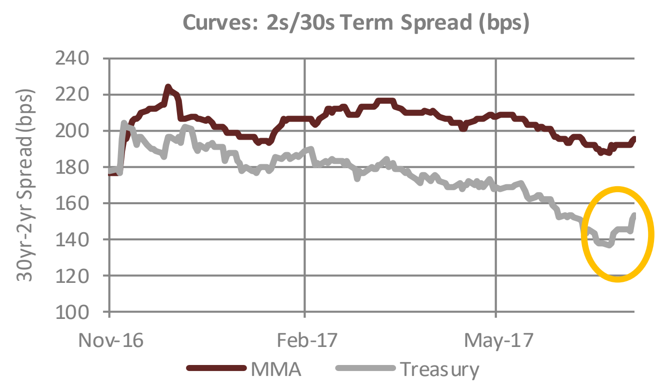


Figure 1: *Last weeks steepening UST curve helped guide the municipal curve steeper as well, though not by the same magnitude.*

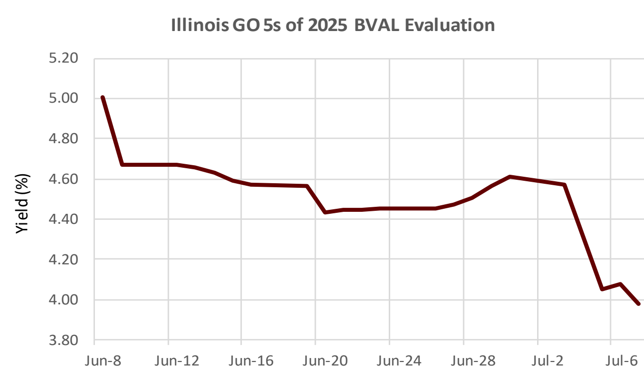


Figure 2: *IL bond trading continued to rally through last week.*

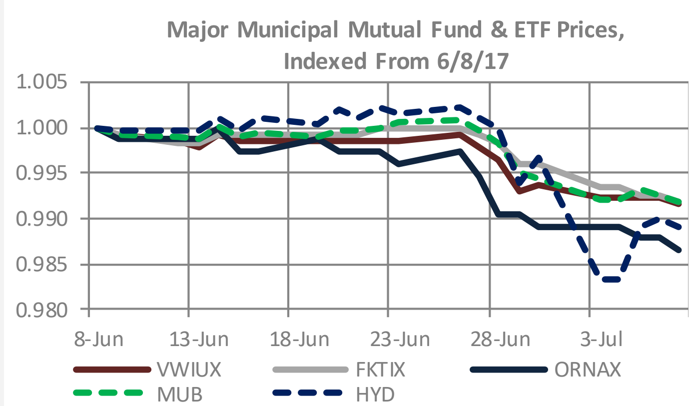


Figure 3: *Key mutual fund and ETF performance has continued to suffer after another week of losses.*

MMA Independent and Data Driven

HilltopSecurities
A Hilltop Holdings Company.

IMPAIRMENT TRENDS AND STATE EVALUATION SPREADS

IMPAIRMENT TRENDS SHOW IMPROVEMENT BUT NOT CONSISTENTLY:

Through 1H17, only 53 municipal borrowers have filed notices of their first credit impairment, down from 65 last year, 71 in 2015, 87 in 2014, 74 in 2013, 112 in 2012, and 130 in 2011. This suggests improving underlying economic conditions (in particular in California, Florida, and Colorado), better access to pre-crisis capital, and a potential tapering of outstanding transactions of the type most vulnerable to impairment and default. It also bolsters the lending activities of bullish high yield investors and thus high yield sector performance and spreads. However, that YTD impairment counts (which show the number of borrowers filing a notice of any kind of credit trouble, including payment defaults, reserve draws, covenant violations, etc.) are elevated in 15 states, including six where impairments are up by at least two.

	YTD Muni Impairments by State (#)						
	2011	2012	2013	2014	2015	2016	2017
TX	9	7	3	9	2	4	9
NY	4	3	4	1	6	4	5
KS	2	1	1	3	4	-	3
MI	3	2	6	5	6	2	3
NV	-	1	-	-	1	-	3
SC	2	-	-	2	-	2	3
AZ	2	8	1	1	1	2	2
CA	9	17	6	12	4	7	2
FL	10	7	6	8	6	3	2
IN	4	1	1	-	2	2	2
LA	2	2	3	1	1	-	2
MN	2	2	2	1	3	2	2
OH	6	3	-	3	-	-	2
PR	1	1	1	-	2	-	2
ID	-	-	-	-	-	-	1
IL	5	6	2	1	2	7	1
KY	-	3	2	4	-	1	1
MO	4	6	5	2	6	2	1
NE	10	4	4	1	-	-	1
NJ	3	-	3	4	1	1	1
OK	5	-	1	1	1	-	1
RI	-	1	-	-	1	-	1
SD	-	-	-	-	-	3	1
WI	2	-	1	1	2	-	1
WV	1	1	-	2	1	-	1
AK	1	-	-	-	-	-	-
AL	3	1	-	-	-	4	-
AR	4	3	6	6	2	-	-
CO	10	14	5	4	2	3	-
CT	1	-	2	-	-	1	-
DC	-	-	2	-	-	-	-
DE	-	-	-	-	-	-	-
GA	7	3	2	2	2	6	-

Texas has the largest increase, with five more borrowers becoming impaired this year versus last, when a water/sewer project, two hospitals, and an IDB all registered covenant trouble. In 2017, three local GOs have filed impairment notices, one of which (Dallas County Schools) is a payment default, one a draw on special reserves (City of La Feria), and one an insolvency (Gainesville Hospital District). Also, Crystal City defaulted on its COPs without explanation. The other TX impairments include two water/sewer districts, two land secured credits, and a jail. Still, these data do not necessarily suggest a generic weakening of Texas credits, as the state—because of its size and rapid growth rate (which attracts more speculative capital)—has had nine 1H impairments twice before (in 2011 and 2014), leading us to expect that 2017's credit performance is likely more of an average where 2015 and 2016's relative scarcity of impairments were the aberration. Similarly, Kansas, with three impairments this year versus zero last, appears to be returning to trend. Nevada, however, is also showing three impairments in 1H for the first time since these data became available (impacting a land secured district, an independent school, and a TIF).

Finally, we note the sharp, unexplained drop in Illinois impairments, from a very diverse seven last year to just one, an IDB in payment default, this year. This implies a bit more bounce to the local Chicago and Illinois economy than suggested by the state's budget crisis. These impairment data will do little to curb investor enthusiasm for Illinois paper at present.

JUNE STATE SPREADS USING BLOOMBERG EVALUATIONS:

The figure below displays state yield spreads to triple-A benchmarks at the end of June vs. the 3-month average spread. They are thus representing the current credit spread of each state vs. its average spread over a period of 3 months. The yields used are Bloomberg's evaluated yields (i.e. BVAL), which are updated each day based largely on transactions. Illinois and Connecticut were among the states with the widest spreads and weakest performance. On June 30th, both states failed to have approved budgets for the new fiscal year (though IL has approved a budget since). Interestingly, Pennsylvania and Wisconsin also did not have approved budgets but were the leading performers. Bond investors thus appear reasonably indifferent to the absence of a budget in the context of their greater near-term need for yield to attract new and retain current assets and customers.