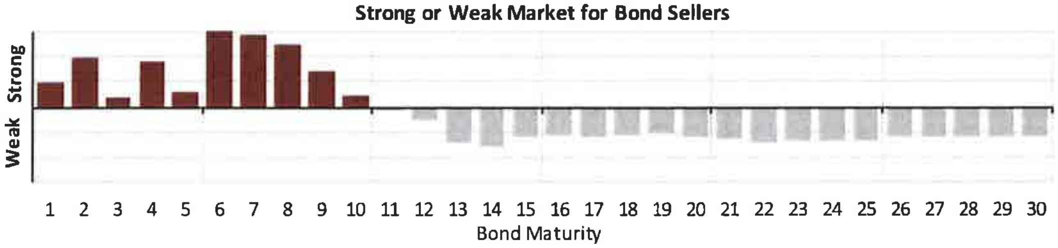
MMA Independent and Data Driven

FirstSouthwest A Division of Hilltop Securities.

MUNICIPAL MARKET JOURNAL



MMA 5% AAA Benchmark

	9/30/2016	9/23/2016	Change
2-yr	0.82%	0.77%	5
5-yr	1.02%	1.00%	2
10-yr	1.53%	1.53%	0
30-yr	2.37%	2.37%	0

Curve dynamics are showing more issuer value than risk at the moment in earlier maturities—suggesting a strong pricing context despite continued short end losses and secondary selling pressure. Further out the curve, the pricing context is showing as softer, perhaps reflecting the vulnerability in the market should mutual fund inflows continue to wane and begin to reverse.

MARKET UPDATE

The fourth quarter begins with another inflection point for the municipal market; near-term risks would appear to favor buyers.

HIGHLIGHTS

- The third quarter ended on a weaker note for **MMA**'s AAA 5%, BVAL AAA, and the U.S. Treasury yield curves, with pronounced tax-exempt losses once again among earlier maturities saturated by incremental secondary market supply.
- Tax-exempt money market fund assets (according to ICI) are down to $131 billion: $53 billion less than on 8/1. VRDO liquidations have cheapened up the front of the yield curve resulting in steadily higher yields, and has unglued correlations with U.S. Treasuries out and beyond the 10-year spot (**Figure 1**).
- Excess VRDO balances have moved the center of gravity in weekly resets further away from 2a7 (money market) accounts, again repricing the SIFMA 7-day index cheaper (to 84 basis points). SIFMA now provides 27 more basis points of yield than 67% of 3-week LIBOR: the most relative value since before the financial crisis (**Figure 2**).
- Despite all this, the front end of MMD did not weaken on Friday (perhaps a quarter end effect reflecting buyer interest in maintaining statement gains), implying that this week's heavy new issue calendar will need even greater spread concessions to clear.
- With mutual fund inflows having slowed slightly (with at least two and likely three weeks-in-a-row of sub-$1B inflows), a greater onus is being placed on crossover investors and retail demand.
- Ultimately, this could dial back underwriters' ability to structure new offerings with sub-5% coupons (**Figure 3 and Page 2**) and might reasonably widen credit spreads, at least for this week.
- Which may present a buyers' market for the first time in months. After all, even long-term investors unhappy with current new issue offerings can comfortably rest their capital in VRDOs, stub securities, and pre-refunded bonds.
- Still, **MMA** remains generally constructive on tax-exempt rates into year-end (and after the 2a7 money market reform deadline on 10/14), so investors buying the front of the curve now should make selections cognizant of credit quality and future liquidity potential.

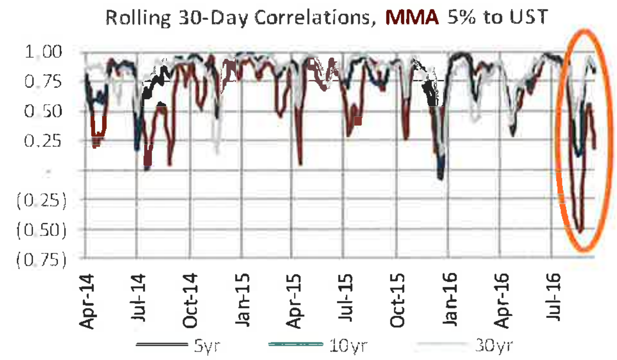


***Figure 1:** Supply and pressure at the front end is disrupting Municipal vs Treasury correlations, creating hedging and risk management challenges.*

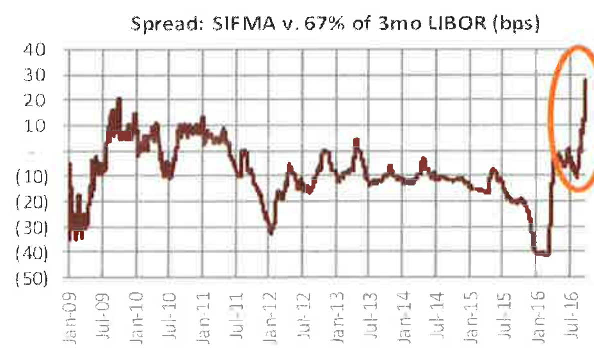


***Figure 2:** SIFMA now cheaper than it was during the financial crisis.*

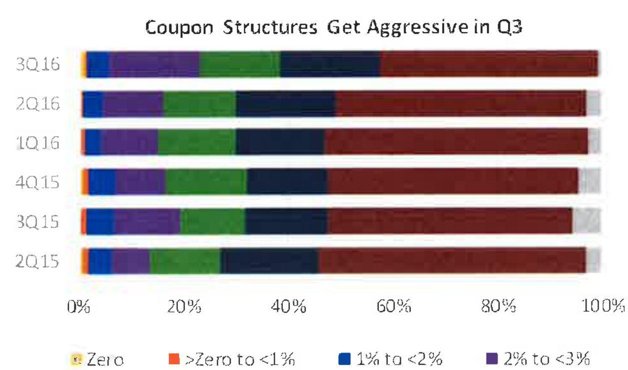


***Figure 3:** More aggressive and institutional buying , and new money issuance, brought out lower coupon structures in 3Q16.*

LOWER COUPON STRUCTURES PREVAIL IN 3Q16

Although persistently low yield conditions have been steadily encouraging municipal investors to capitulate on structure and accept lower coupon bonds, issuance of sub-5% bonds exploded in 3Q16, rising to 56.4% of all newly issued bonds from 48.8% in 2Q and 46.5% in 1Q16 (all numbers excluding zeros) (**Figure 3**). Besides blaming the low yield environment and more intense competitive pressures to reinvest maturing principal, we note:

1) An even greater reliance on structurally-more-aggressive mutual fund and discretionary buying platforms versus traditional retail, itself a function of steadily lower yields (which leave retail investors uninspired) and the ever-higher regulatory burden on broker-dealers running a transactional retail business.
2) Relatedly, demand in 3Q16 appears to have better guided by total return and/or cross-market/hedged investing strategies, which, as did the TOBs in 2005, repriced the market away from "regular" income-oriented and price defensive investors. In theory, this dynamic argues for an amplified market downside if prices begin to fall more reliably and chase away momentum seekers. And despite regulatory and electronic trading innovations, it is doubtful that the municipal market's emergency liquidity is much structurally improved versus the last crisis. However, **MMA** assumes that: (a) the new buyers are a more resilient source of capital than were pre-crisis TOBs, all else being equal; and (b) today's traditional investors, starved of both par and portfolio income, are likely to respond with more alacrity to higher yields than in 2008.
3) Lower coupons in 3Q16 also reflect a renewed emphasis on slightly-less-yield-sensitive new money bond sales in the primary market and/or a further ramping up of competition between underwriters with purveyors of low coupons becoming willing to forego some future refunding opportunities.
4) Less coupon income implies slightly less income to be protected with bond insurance and thus less demand for the product overall. It is thus unremarkable that the overall bond insurance penetration rate fell to 5.3% in 3Q16 vs. 5.8% in 1H16. Frankly, that the insurers could maintain a +5.0% market share despite falling yields and credit spreads, more aggressive couponing, favorable default trends, and massive headline risk over Puerto Rico is a positive for the industry.
5) Finally, this is not a simple shift in maturity. In fact, the share of issuance with a 10yr maturity or less actually shrank in 3Q16 (41.2%) vs. 1H16 (42.3%), implying a slightly more dramatic shift in couponing assumptions than the surface data show.

IMPACTFUL BOND DEALS AND ASSOCIATED TRADING

***Below** are **four** new primary deals that have impacted the market recently with associated secondary trading dynamics:*

Hawaii

9/29: **Citigroup Global Markets Inc.** priced $758M general obligation bonds; Aa1/AA+/AA; callable at par in 10/1/2026:

Pricing Notes: Levels across the curve were cut to higher yields on institutional re-pricing on a weaker trading session. Deal was downsized by $100M.

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.00	+19
2026	4.00	1.74	+23
2036pc	4.00	2.63	+48

Secondary Trading: Institutional trading was limited but today (Mon.) the 5s of 2024 traded 1 basis point weaker than originals.

Commonwealth of MA

9/29: **Morgan Stanley & Co.** priced $241M commonwealth transportation fund revenue bonds; Aa1/AAA/NR; callable at par in 6/1/2026:

Pricing Notes: Deal was re-priced with 5bp cuts in the longest maturity. Deal was downsized $194M before closing accounts.

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	0.87	+5
2026	4.00	1.56	+5
2041pc	5.00	2.40	+11

Secondary Trading: There were few block trades but today the 4s of 2019 traded at original levels (0.87%).

Board of Regents of the Univ. of Texas System

9/29: **Barclays Capital Inc.** priced $234M revenue financing system refunding bonds; Aaa/AAA/AAA; callable at par in 8/15/2026:

Pricing Notes: The 10-year maturity was well received and bumped to lower yields by 3-basis points on institutional re-pricing. Otherwise most maturities were steady on re-price.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.12	+13
2026	5.00	1.66	+15
2031pc	3.00	2.57	+68

Secondary Trading: New issue tickets printed at originals on Friday, but there were no block trades on Monday.

Mecklenburg, NC

9/29: In the competitive space, **Citigroup Global Markets Inc.** was high bid on $200M general obligation improvement bonds; Aaa/AAA/AAA; callable at par in 12/1/2026:

Pricing Notes: Deal was structured with a combination of 2.125%, 3%, and 5% coupons.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.00	+1
2026	5.00	1.50	-1
2031	2.125	2.37	+48

Secondary Trading: On Monday (today), the 2031 maturity with a 2.125% coupon traded 6 basis points weaker than originals.