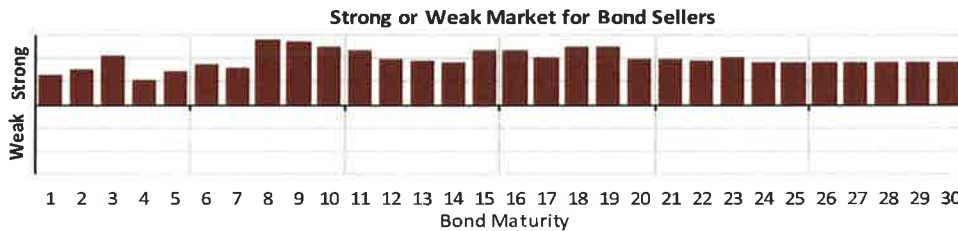


MUNICIPAL MARKET JOURNAL



MMA 5% AAA Benchmark

	11/4/16	10/28/16	Change
2-yr	0.87%	0.90%	-3
5-yr	1.16%	1.17%	-1
10-yr	1.75%	1.76%	-1
30-yr	2.64%	2.66%	-2

The municipal curve is generally indicating an overbought condition, thus bond holders should be looking to sell today, and buyers should take a wait and see approach. Ahead of the election, caution should be the key word as bonds almost surely contain more downside potential than opposite. Benchmark spots (5-year and 10-year) being the most liquid trading candidates should lead the way if volatility does exist. Municipal issuers are positioned to take advantage of overbought conditions today.

MARKET UPDATE

The election holds potential for a sharp, but probably temporary downside in fixed income prices generally.

HIGHLIGHTS

- Municipal yields edged lower last week, lagging a 5-9 basis point jobs-oil-and-Fed rally in Treasuries, and pushing relative value ratio's higher above their 3-month averages (**Figure 1**).
- The macroeconomic message remains mixed, with the Fed seen as likely to hike rates in December despite tame inflation expectations, lower oil prices, and underperforming jobs gains.
- Tomorrow, a thinly-traded election/holiday week permits elevated post-election volatility. Trading began to thin late last week as daily par traded registered below averages (**Figure 2**), and has been well below same-day weekly averages all day today.
- Assuming that the stock market will rally with a Clinton victory (more exactly, a Trump loss), bonds would face downside pressure if recent polling turns out to be accurate. Were instead Trump to win, a flight to safety would reasonably send bond prices higher.
- However, tax-exempts still carry signs of strength, led by rapid declines in the 7-day SIFMA index, which is now down to 56 basis points (**Figure 3**). Along with last week's first +\$1B inflow into municipal money funds since early August, it is not unreasonable that generic Street expectations for a post-10/14 recovery on 2a7 demand are materializing. That these same accounts are carrying 50+ basis points more yield than they were nine months ago should mean some momentum behind this repositioning.
- This implies a reduction in excess secondary supply at the front of the curve as distribution eases, and could help explain at least a portion of the mutual fund outflows shown by Lipper.
- Such a development is reasonable, noting last week's relative strength despite the outflows. Most new offerings traded up well last week, led by the \$588M Port Authority of NY and NJ bonds trading to yields 7 basis points below their original.
- These trades are signals that the demand side, likely still short of portfolio coupon income targets, remains constructive and, at a minimum, is poised to keep even a down market orderly and make near term losses more temporary than otherwise.

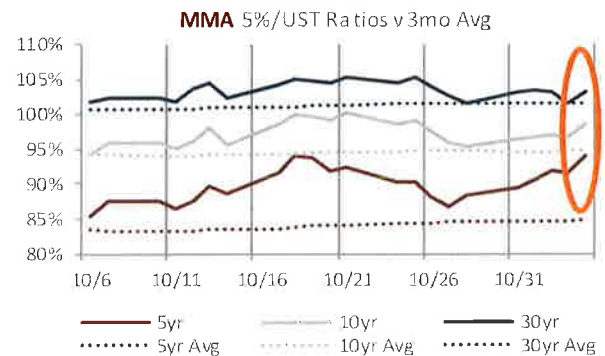


Figure 1: Municipals appearing as "cheap" relative to recent averages, especially at the 5-year. New crossover demand is reasonable.

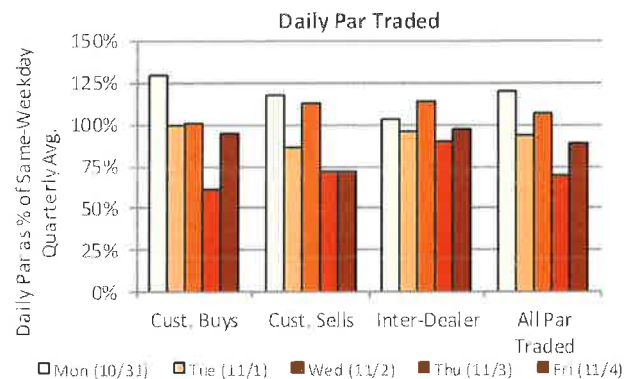


Figure 2: Trading activity declined broadly in the latter half of last week, perhaps a precursor to this election/holiday-shortened week.



Figure 3: SIFMA now rallying back to more normal levels.

MORE PRESSURE, NEGATIVE RATING ACTIONS FOR STATES

The highly rated US state sector faced significantly more rating downgrades than upgrades in the first three quarters of 2016. Unlike some other municipal sectors, rating agencies' opinions seem to be well-aligned on where the largest problems are (which states) and what is driving the credit deterioration. The critical challenges cited include slowing revenue growth, rising legacy costs and concentration in the oil and gas industry. Many of the pressures facing states are not likely to abate in the short-run and these entities and we expect that over the near-to-medium-term there will be more downgrades and greater spread-widening for state credits, particularly as greater clarity into OPEB obligations arrives with the implementation of new GASB rules. State challenges will reasonably be negative for the local government and public higher education sectors that rely on state aid.

The pressured oil and gas industry continued to play a significant role in rating actions in 2016. AK, LA, ND, NM and WV saw their ratings cut as revenues related to industry activities continued to fall. Legacy costs are plaguing IL, CT and KS making them a key driver in weakening the credit positions of these states. But they are not alone, NJ, PA and KY—which have not been downgraded so far in 2016—are also facing significant challenges in the funding of pensions and/or OPEBs. And the slowing of state revenues, particularly while the US is still in an expansionary period, is an overall concern for sector credit quality as costs continue to escalate more rapidly. The state sector will likely have less available resources and flexibility to weather the next economic downturn.

Many states are facing revenue and budget pressures as previously slowing revenues turned negative in Q2 2016, according to a report by the Rockefeller Institute. In Q1 2016, revenues grew at a disappointing 1.6% down from an average of 4.5% over the prior 4 quarters. But Q1 was strong compared to the outright decline of -2.1% in Q2. Total state revenue weakness stems from pervasive and idiosyncratic factors including; a) the stock market's lackluster performance in 2015 and weakness during the first half of 2016 that affected personal income tax collections, particularly estimated taxes and final payments; b) suppressed sales tax revenue growth driven by an older and more cautious consumer base and the strength of online purchases that adversely impact the collection of sales taxes as spending shifts away from bricks-and-mortar establishments; and c) oil price declines and lower production that have reduced severance taxes and affected personal income tax revenues and sales taxes because of the negative impact on jobs and consumer spending.

IMPACTFUL BOND DEALS AND ASSOCIATED TRADING

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

Chicago, IL

11/3: **Bank of America Merrill Lynch** priced \$1.018B O'Hare International Airport senior lien revenue refunding bonds for **Chicago, IL**; NR/A/A; callable at par in 1/1/2026:

Pricing Notes: Non-AMT bonds were bumped as much as 10 bps in spots during afternoon re-pricing.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.38	+22
2026	5.00	2.28	+53
2041	5.00	3.23	+64

Secondary Trading: On Monday (today), several maturities broke into the secondary 3 to 5 bps firmer than originals.

Illinois

11/3: **Illinois** sold \$480M general obligation bonds to **Bank of America Merrill Lynch**; Baa2/BBB/BBB+; callable at par in 11/1/2026:

Pricing Notes: BAML won the bonds with a true interest cost of 4.2449%; spreads widened relative to the state's offering in June.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	2.88	+172
2026	5.00	3.70	+195
2041	5.00	4.48	+189

Secondary Trading: Last Friday, the 5-yr bond with a 5% coupon traded at 2.98% compared to an original yield of 2.88%.

Port Authority NY & NJ

11/1: **Citigroup Global Markets Inc.** priced \$588M AMT and non-AMT consolidated bonds for the **Port Authority of NY & NJ**; Aa3/AA-/AA-; callable at par in 11/15/2026:

Pricing Notes: \$238M AMT bonds & \$350M non-AMT bonds were re-priced with modest bumps in spots; non-AMT yields are below:

Maturity	Coupon	Yield	+/- AAA 5%
2027	5.00	2.07	+19
2036	5.00	2.72	+26
2046	5.00	2.91	+25

Secondary Trading: Last Thursday, non-AMT bonds in 30- and 40-yr traded 6 bps better than originals; 5s of 2034 improved by 8 bps.

DASNY

11/1: **Goldman, Sachs & Co.** priced \$318M new school revenue bonds for the **Dormitory Authority of the State of New York**; A3/A-/NR; callable at par in 1/1/2027:

Pricing Notes: All 5 handles except bonds in 2033 & 2034 were offered with 3.25% coupons; 2043 maturity offered with 4% coupon.

Maturity	Coupon	Yield	+/- AAA 5%
2026	5.00	2.36	+60
2036	5.00	3.14	+68
2046	5.00	3.28	+62

Secondary Trading: On Monday (today), the 4s of 2043 traded at 3.62% compared to an original yield of 3.70%.