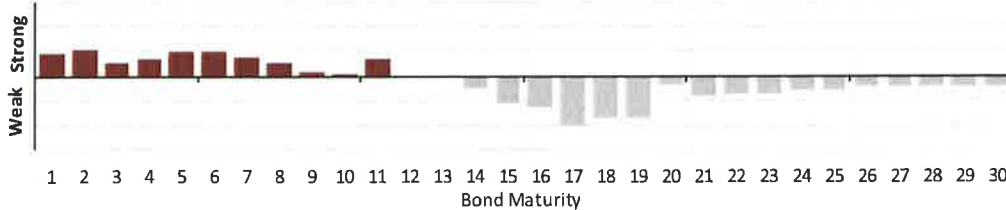


# MUNICIPAL MARKET JOURNAL

## Strong or Weak Market for Bond Sellers



## MMA 5% AAA Benchmark

	10/14/2016	10/7/2016	Change
2-yr	0.88%	0.86%	2
5-yr	1.14%	1.10%	4
10-yr	1.72%	1.65%	7
30-yr	2.62%	2.51%	11

The front of the curve—through 8-years—is reading as “overvalued” based on MMA’s valuation metrics, indicating a more aggressive pricing context to be expected by the issuer; however, the larger secondary market supply of VRDOs and shorter bonds is likely not being fully appreciated by these measures. Longer maturities are reading as generally cheap, creating more buyer opportunity for near-term gains, but also indicative of a more concessionary pricing environment at the moment for new issues.

## MARKET UPDATE

For the first time in months, municipal bond buyers have the product to reinvest maturing principal, although still current low yields are not yet acceptable to long-term, traditional investors.

## HIGHLIGHTS

- Municipal yields rose again across a steeper curve as strong primary and secondary supply continues to force bond seller concessions. Fed minutes revealed a board likely more biased to near-term hawkishness than anticipated.
- The recent backup in prices has eroded all or essentially all of year-to-date gains in mutual fund NAVs, and fund inflows have tapered accordingly (Figure 1). It is not unreasonable that fund flows will turn negative in the next few weeks.
- While VRDO balances have come down via a likely over-correction in the 7-day SIFMA rate (i.e., the current rate is 83bps or roughly 15bps cheaper than a more historically consistent level, which would be +9bps to 67% of 3-month LIBOR), dealer balance sheets are still extremely heavy (Figure 2).
- Underperformance of municipals versus US Treasuries exhibited by a rise in M/UST ratios (Figure 3) is also problematic by adding to the cost of hedged portfolios—like dealer inventories that use Treasuries to hedge their long municipal cash balances. This trend biases the new issue market to come with wider spreads so as to clear more quickly, all else being equal.
- A massive primary continues (as it may into the election), led by a near \$900M Georgia GO competitive deal on Wednesday that will act to provide triple-A benchmark price discovery.
- The current market appears to be headed for at least modest correction assuming US Treasuries remain generally unimpaired and no new headline developments occur.
- Bondholders have found some protection lately in the new issue market, where major new issues were generally able to stick closer to initial pricings despite broad market cheapening. In some cases, as with the Illinois bond issue, newly wider spreads actually tightened slightly when trading commenced (See page 2).
- Lastly, in general, note the capitulation of the offered side, indicated by continuing tightness in the spread between MMA and offering levels.

## 54 Consecutive Weeks of Inflows: Lipper



Figure 1: Mutual fund inflows declining, but still positive. Negative fund flows could pressure a market with heavy new issue.

## Fed: Primary Dealer Net Positions in Muni's (\$B)

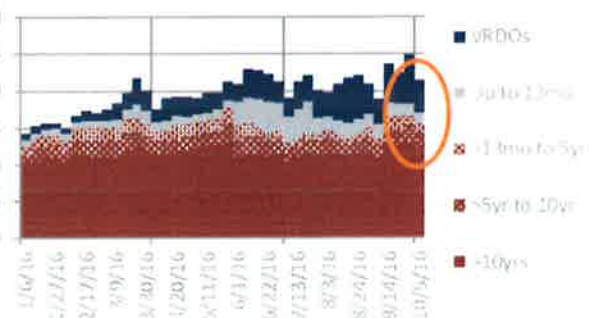


Figure 2: Dealer holdings have declined, but only slightly, challenging capital commitment.

## MMA 5% as a % of UST vs. 6-mo. Avg.

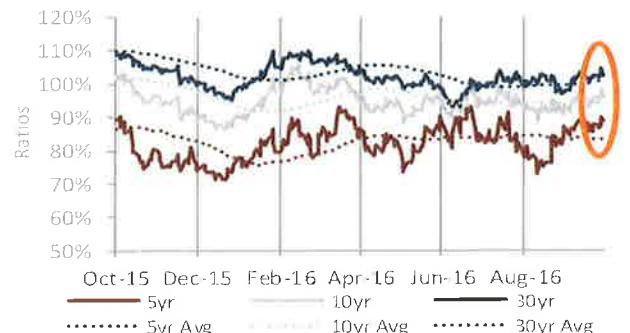


Figure 3: Increase in Muni vs Treasury ratio's can attract crossover demand, but have also created hedging challenges for unsold dealer balances.

**CITY FISCAL CONDITIONS IMPROVE BUT CHALLENGES AHEAD**

Decelerating growth in revenues and rising expenditures threaten the recent gains in fiscal stability of the US cities sector. And given the trend of weaker support for local governments by states—because of concerns for their own fiscal health, ratings, or general apathy—cities are increasingly vulnerable, potentially warranting severe policy adjustments, bankruptcies, and/or elevated defaults during the next economic downturn. The current economic recovery is in its 8th year, well beyond the average US post-recession expansion. Even if another recession does not materialize over the next decade (which is unlikely), the overall (average) credit quality of this market segment will likely decline.

The ability of cities to respond to challenging fiscal conditions depends on their individual revenue structures, economies, revenue raising constraints, and reserves. Those with diverse funding sources that are able to leverage their economic realities to optimize revenues will be better positioned over the longer-term. But, many cities lack flexibility on the revenue side to control their destinies (e.g. not authorized to levy certain types of revenues or constrained in their application, legally or politically) and have already squeezed spending in the wake of the Great Recession. These dynamics leave few functional levers for cities with limited flexibility.

To increase revenues within their operating reality, cities have generally become much more reliant on raising user-fees and implementing new ones. These revenue increases are often less scrutinized and therefore more politically expedient/friendly, but they may not be sufficient in scope or size to address ever-growing expenditures in future years, particularly as user fees tend to reduce usage of facilities and thus economic growth, worsening aggregate tax receipts. Coordinated state-local efforts to ease local tax raising limitations or authorize other revenue sources would be helpful but difficult to do and thus are unlikely to happen.

**National League of Cities (NLC) survey results:** The good news for cities is that revenues and local employment have been on the rise and are near their pre-recession peaks. Positively, 2015 general fund revenues were up 3.73% and ending balances were approaching 25% of general fund expenditures according to the NLC’s recent *City Fiscal Conditions report*. 81% of finance officers that responded to the NLC’s current survey said that they felt they were better able to meet the financial needs of their communities, the second highest percentage on record since 1990.

**IMPACTFUL BOND DEALS AND ASSOCIATED TRADING**

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

**Illinois**

10/13: **Bank of America Merrill Lynch** priced \$1.317B GO refunding bonds; Baa2/BBB/BBB+; bonds in 2030-2032 are AGM insured (A2/AA/NR); callable at par in 2/1/2027:

**Pricing Notes:** Deal was re-priced with no adjustments on uninsured bonds, but was bumped lower in yield by 3-12bp on insured portions.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	2.34	+147
2026	5.00	3.63	+193
2031 (AGM)	4.00	4.07	+196

**Secondary Trading:** Secondary breaks were firmer; specifically the 5s of 2023 traded 2bp better, and the 4s of 2030 traded 3bp better.

**Cypress-Fairbanks ISD, TX**

10/13: **Raymond James & Associates** priced \$446 unlimited tax school building and refunding bonds; Aa1/AA/NR; PSF guaranteed (Aaa/AAA/NR); callable at par in 2/15/2016:

**Pricing Notes:** Deal was re-priced with minor bumps to lower yields in 2019, 2031 and 2036.

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.04	+6
2031pc	3.50	2.78	+67
2036pc	4.00	2.92	+53

**Secondary Trading:** Bonds broke firmer in secondary trading on Friday; 4s of 2034 and 2036 both traded 2bp better than originals.

**IDA of Maricopa, AZ (Banner Health)**

10/12: JPMorgan Securities LLC priced \$807M Banner Health revenue bonds for the IDA of Maricopa County, AZ; NR/AA-/AA-; callable at par in 1/1/2027 except bonds maturing in 2028 and 2029:

**Pricing Notes:** Bonds were bumped to lower yields in shorter maturities; left unchanged in intermediate and longer maturities.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.35	+23
2026	5.00	2.14	+46
2036pc	4.00	3.40	+105

**Secondary Trading:** Bonds broke firmer in secondary trading; 4s of 2038, 3.25s of 2037 and 3.125s of 2033 all broke to firmer levels.

**Long Island Power Authority**

10/13: **Goldman, Sachs & Co.** priced \$408M electric system general revenue bonds; A3/A-/A-; callable at par in 9/1/2026:

**Pricing Notes:** Deal was repriced with 2-5 basis point bumps to lower yields on most offered maturities.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.45	+32
2026	5.00	2.22	+52
2046pc	5.00	3.16	+57

**Secondary Trading:** 5s of 2046 traded in block size on Monday afternoon at 3.15% vs. original of 3.16%.