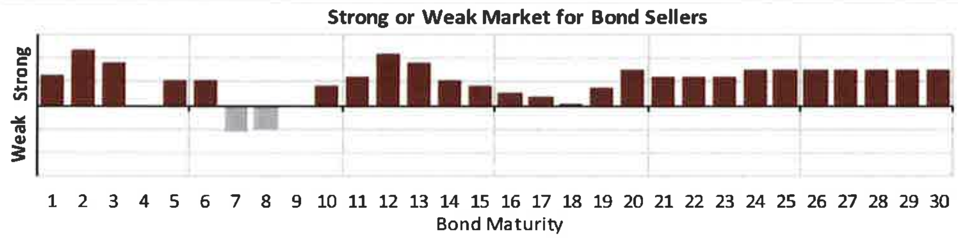
MUNICIPAL MARKET JOURNAL



MMA 5% AAA Benchmark

	10/28/16	10/21/16	Change
2-yr	0.90%	0.87%	3
5-yr	1.17%	1.15%	2
10-yr	1.76%	1.74%	2
30-yr	2.66%	2.62%	4

Despite an overvalued opinion based on MMA's mean reversion indicators, bond buyers are likely to still see the strongest price appreciation prospects at the front of the curve. This assumes the short term market continues to resolve it's pre-money-market-reform issues and prices begin to realign with more normal expectations. By contrast, the long end (20-years and longer) appears uniformly rich, implying pricing expectations for issuers are strong—but perhaps only temporarily.

MARKET UPDATE

The municipal market has displayed some nascent signs of improved primary distribution. Still, Friday's jobs data and the new uncertainty around the Presidential election may sustain investor caution for risk.

HIGHLIGHTS

- For the 4th consecutive week, tax-exempt yields ended higher, weakening 2-3 basis points across an otherwise steady yield curve.
- The longest maturity yields have now risen 31 basis points versus the end of September, and, in a change from pre-October market dynamics, maturity term spreads have begun to rise more meaningfully, the 2s/30s increasing by 18 basis points, (**Figure 1**).
- However, this is less a sign of distress than resolution, with specific reference to (at least temporarily) improving conditions in the short-term market post 2a7 money market reforms. The SIFMA 7-day rate has fallen 20 basis points from its peak and now approximates a more historically consistent +5 basis point spread to 67% of LIBOR (**Figure 2**).
- That rally highlights better customer buying of VRDOs, a point also shown in the 65% drop in primary dealer inventories of VRDOs in the last three weeks — helpful for underwritings this week.
- Also, the more accurate ICI data showed no weekly aggregate outflows for tax-exempt mutual funds—investors are engaged though cautious.
- That term spreads haven't widened more also suggests relative order in the rest of the municipal market. Note **Figure 3** which shows how, despite the sharp yield increase since 10/1, customer selling levels have held generally steady.
- Regardless of where an actual secondary market bid side exists (e.g., at or cheap to existing levels), bond holders are not demanding liquidity from dealers, are not being forced to discount lower rated/riskier positions, and are not suffering intemperate outflows.
- Accounts thus appear generally complacent and, are likely satisfied with the incremental yield and/or performance upside now being provided by the primary market.
- This week's new issue calendar is smaller and, assuming some stability in US Treasuries, there is no reason to assume break out changes in the municipal market at large baring new political headlines or disruptive economic data, i.e. October jobs report.

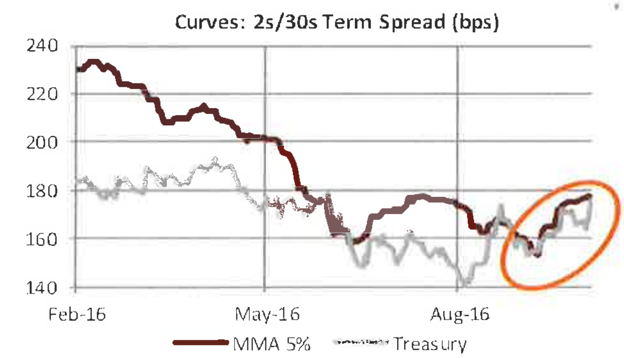


***Figure 1:** 2s/30s term spread now at late summer highs, softening benefits of advanced refundings.*

***Figure 2:** SIFMA has recovered (i.e. declined) to a historically more consistent spread to LIBOR.*

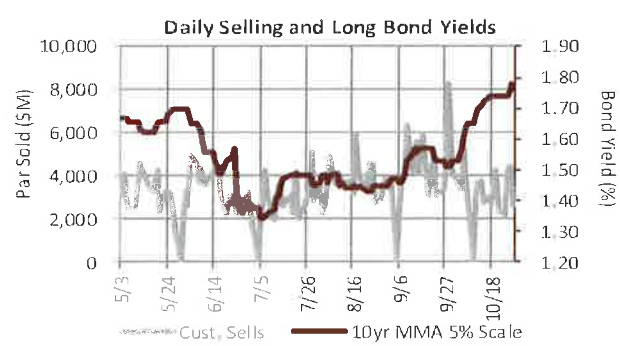


***Figure 3:** An increase in yields has not coincided with customer selling, implying an absence of a need for secondary liquidity in light of a heavy new issue calendar and associated distribution of primary issues.*

DEFAULTS LIKELY TO RISE IN 2016 BUT CHAPTER 9S REMAIN SCARCE

Defaults: With a spurt of 9/1 and 10/1 defaults related to two multi-state retirement project clusters, the number of YTD first time payment defaulters in 2016 (52) has broken above last year's trend (48 between January and October). In order for this year to finish with fewer defaults than last year (a trend that has held every year since **MMA** began collecting this data in 2009), there can be no more than six (6) additional defaults in November and December. Those two months have together averaged 14 defaults since 2013, strongly suggesting that 2016 will see a break in the downtrend. It is likely too early to know for sure if these data are: 1) a temporary break in what is still a trend toward lower default counts; 2) merely noise as municipal default incidence slides along at a relatively low average pace; or 3) a more meaningful trend depicting actual worsening credit conditions. Although most of the new defaulters are linked entities that have been in our database for over a year, **MMA** is inclined to accept the idea that system-wide default trends may be turning negatively, noting circumstantial evidence in softer economic indicators, poor state revenues, a lack of momentum in the all-important real estate sector of the national economy, and the rising corporate bond default rate. If correct, municipal default rates could see some acceleration in 2017 since the newly-issued 2015 and 2016 vintages of risky sector bonds have been aggressively structured and may be ill prepared for an unexpected economic downturn.

Bankruptcies: The City of San Bernardino is very close to ending its chapter 9 bankruptcy after four years, reducing the number of ongoing municipal bankruptcy cases to eight and the number of ongoing non-special district bankruptcies to zero. Remember that the City of Hillview, KY chapter 9 was terminated in May following the city's settlement with the corporation that had received an outsize legal judgement against it. Small rural hospital districts represent five of the ongoing chapter 9 bankruptcies, land development districts the remaining three. It remains extremely likely that future city bankruptcies (along with special political restructurings like that in **Puerto Rico**) will continue to validate pensioners' political seniority vis-a-vis bondholders with recoveries favoring the former. And cities that file for chapter 9 have seen little immediate or direct financial relief, remain challenged to improve current and future operations, and present as reasonable, if not likely, candidates for filing new bankruptcies in the future. This is backed by the data: of the eight ongoing chapter 9s right now, three involve repeat filers: **Palm Drive Health Care District** in CA (which had filed in 2007 and again in 2014), **Lake Lotawana Community Improvement District** in MO (filed in 2010 and again in late August 2016), and **West Contra Costa Healthcare District** in CA (filed in 2006 and again two weeks ago).

IMPACTFUL BOND DEALS AND ASSOCIATED TRADING

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

NJ Transportation Trust Fund Authority

10/26: **BAML** priced $2.741B federal highway reimbursement revenue notes for the **NJ Transportation Trust Fund Authority**; A3/A+/A-; the first series is $1.441B bonds, callable at par in 6/15/2026:

Pricing Notes: The issuer offered bonds with a 2018 call and a 2026 call option (below); both series' were bumped during re-pricing.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	2.58	+143
2025	5.00	3.37	+174
2031	4.10	4.10	+197

Secondary Trading: On Monday (today), 5s of 2022 (C18) traded 5 bps better than Friday and 25 bps firmer than originals.

CA Health Facilities Fin Authority

10/26: **Barclays Capital Inc.** priced $677M Cedars-Sinai Medical Center revenue and refunding revenue bonds for the **CA Health Facilities Financing Authority**; Aa3/NR/AA-; callable at par in 8/15/2026:

Pricing Notes: The issuer offered different coupon structures for several of the maturities.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.24	+9
2026	5.00	2.04	+30
2039	4.00	3.32	+80

Secondary Trading: On Monday (today), 3s of 2034 traded at 3.25%, which is consistent with originals.

MD DoT

10/26: The **Maryland Department of Transportation** sold $385M consolidated transportation bonds to **Bank of America Merrill Lynch**; Aa1/AAA/AA+; callable at par in 11/1/2024:

Pricing Notes: BAML won with a true interest cost of 2.31%; the issuer also sold $242M bonds to JPMorgan with a TIC of 1.56%.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.13	-2
2026	5.00	1.73	-1
2031	3.00	2.80	+67

Secondary Trading: On Thursday, the 5s of 2024 traded at 1.59% compared to an original yields of 1.49%; traded at 1.59% on Friday.

N Texas Municipal Water District

10/27: The **North Texas Municipal Water District** sold $330M water system revenue refunding and improvement bonds to **Bank of America Merrill Lynch**; Aa2/AAA/NR; callable at par in 9/1/2026:

Pricing Notes: BAML won the deal with a true interest cost of 3.28%; this was the largest offering of the day.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.34	+19
2026	5.00	2.01	+26
2046	4.00	3.15	+51

Secondary Trading: On Monday (today), the 5s of 2027 traded 3 bps stronger than originals (2.09% vs. 2.12% orig).