MMA Independent and Data Driven

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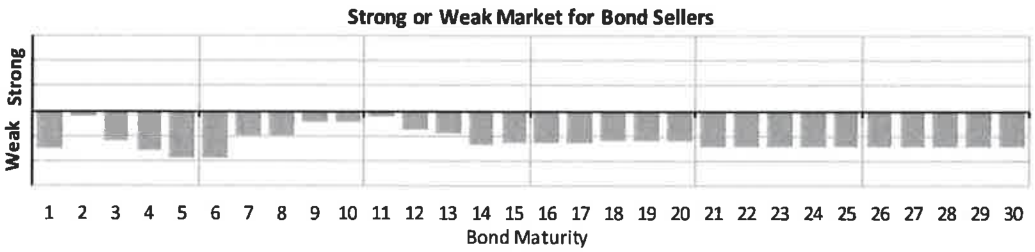
MUNICIPAL MARKET JOURNAL



MMA 5% AAA Benchmark

	9/23/16	*9/16/16*	*Change*
2-yr	0.77%	0.73%	4
5-yr	1.00%	1.03%	-3
10-yr	1.53%	1.57%	-4
30-yr	2.37%	2.40%	-3

Recently higher yields from a weak start to September, combined with a now more promising price trend heading into quarter end, has created a strong perception of buyer value along the curve—and as a result a more concessionary pricing environment for new deals today, but offering support for solid buyer demand for new issue through the week.

MARKET UPDATE

Municipals should be poised for a rally into month- and quarter-end, but longer term there are concerns about inconsistent correlations with taxables and less-than-predictable liquidity, if yields were to rise.

HIGHLIGHTS

- For the most part, the municipal bond market remained orderly last week, with yields rising at the front of the curve given continued disruption in the short-term market. Long yields fell slightly, in tune with the Treasury curve and a still-patient Fed.
- The front-end losses deserve some recognition, however, particularly with respect to U.S. Treasuries, noting how the 7-day SIFMA tax-exempt borrowing rate has now risen 14 basis points since mid-September while the 4-week Treasury yield has fallen 17 basis points. In fact, versus LIBOR at least, SIFMA is now as cheap (i.e. higher in yield relative to LIBOR) as it has been since the financial crisis in 2009 (**Figure 1**).
- Ultimately, this is a function of ongoing money market fund reform, but the rising 7-day rate unglued the rolling 30-day fixed rate correlations with Treasuries as far up the curve as the 10-year.
- Although the front end did stabilize demand with higher yields, another massive round of VRDO liquidations out of money funds last week pushed dealer balance sheets back to their highest levels since April 2015—limiting dealer capital commitment (**Figure 2**). That may well impair current trading correlations again and, if this week weren't the end of a quarter, set municipals to underperform.
- But this IS the last week of 3Q16, and, despite recent seasonally-inconsistent performance, the historical bias is solidly positive into Friday. In fact, the tailwind may be strong enough to push currently cheap muni/Treasury ratios lower if taxable buyer accounts choose to boost risk positions by buying municipals into month end.
- That could allow another large new issue calendar an easy distribution, despite recent elevated levels of secondary selling pressure.
- As for mutual funds, inflows have continued, albeit at a slightly weaker pace. YTD inflows are now above $50 billion.
- And trading volumes—driven entirely by customer activity given elevated primary issuance—are at their highest point since 2013's taper tantrum (**Figure 3**).

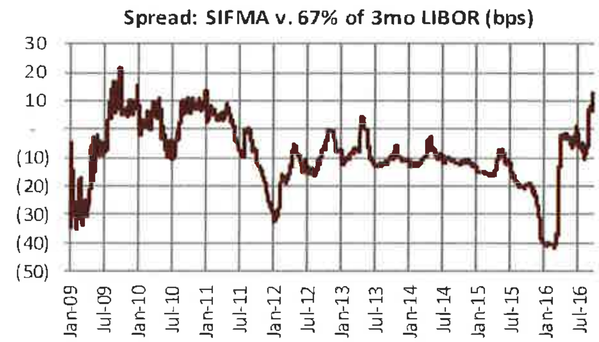


Figure 1: SIFMA has become as cheap (i.e. bps spread above 67% of Libor) as it was during the financial crisis.

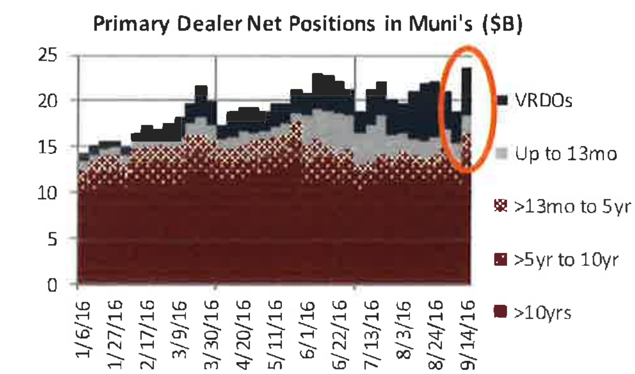


Figure 2: Dealer holdings highest since April 2015—exhibiting difficulties in capital commitment to municipals.

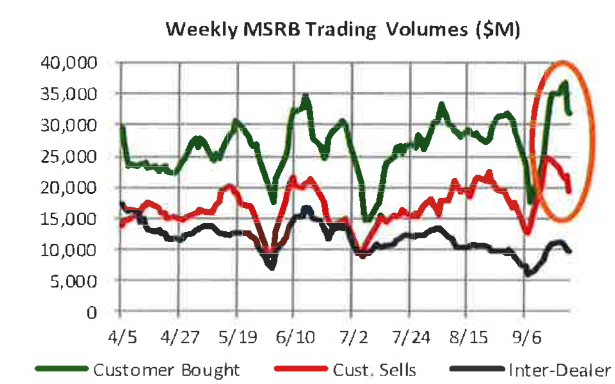


Figure 3: Heavy primary issuance has elevated customer trading flows.

STATE REVENUE MISSES FORESHADOW BUDGET TROUBLE

Many states are facing the growing prospect of midyear budget gaps as previously slowing revenues turned negative in Q2 2016, according to a report by the Rockefeller Institute. This means an increasing likelihood of negative headlines, more negative rating trends, and resulting price volatility in the state and local government sectors. Weaker than budgeted revenues and more rapidly growing costs (e.g. pension and OPEB benefits, Medicaid) are likely to force many states to make tough decisions this budget cycle, including spending cuts, drawing budget reserves and contemplation of tax increases. To the extent states rely on budget gimmicks (which would be typical behavior for mid-year adjustments) rating downgrades are likely to follow. Local governments, which have generally been faring better owing to the housing recovery and growth in property taxes, are at an increased risk of state-aid reductions if state revenues do not pivot to the upside.

Contributing factors: Total state revenue weakness stems from pervasive and idiosyncratic factors. 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. And while FY17 budgets were not projecting strong revenue growth, the combination of a lower starting point for the fiscal year (because of the weak FY16 performance) for many states and the negative revenue trend in recent quarters will likely make it harder for state revenues to reach forecasted levels.

The volatile stock market's lackluster performance in 2015 and weakness during the first half of 2016 affected personal income tax collections, particularly estimated taxes and final payments. The market has rebounded and now owns a better but still not stellar return. Unless the equity market rallies through the end of the year, personal income tax revenue growth may fall short of states' FY17 projections. And while sales tax revenue growth remains positive, it is hampered by, among other things, an older and more cautious consumer base, as well as the strength of online purchases and states' difficulties in fully realizing would-be sales taxes lost as spending shifts away from bricks-and-mortar establishments.

IMPACTFUL BOND DEALS AND ASSOCIATED TRADING

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

Central Florida Expressway Authority

9/22: **Bank of America Merrill Lynch** priced $615M senior lien refunding revenue bonds; A2/A/A; bonds maturing in 2036 and 2037 with 3% coupons were offered with AGM insurance (A2/AA/NR); bonds callable at par in 7/1/2026:

Pricing Notes: Levels inside 2031 were bumped 3-8bps on re-price.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.31	+28
2031pc	4.00	2.66	+72
2040pc	4.00	3.07	+74

Secondary Trading: On Monday, the 4s of 2040 traded 2 basis points weaker than originals.

Texas Water Development Board

9/20: **Bank of America Merrill Lynch** priced $599M state water implementation revenue fund bonds; NR/AAA/AAA; callable at par in 10/15/2026:

Pricing Notes: Deal was re-priced with 2 basis point bumps to lower yields, and structured with 3, 4, 5 and 5.25% coupons.

Maturity	Coupon	Yield	+/- AAA 5%
2018	4.00	0.78	+4
2026	4.00	1.71	+14
2046pc	5.25	2.50	+10

Secondary Trading: On Thursday, 5s of 2041 broke 3 bps better than originals; On Friday, 4s of 2032 traded 5 bps firmer than orig.

Dormitory Authority of New York

9/22: This was a three part competitive sale, with **Bank of America Merrill Lynch** high bid on $690M, and **J.P. Morgan** high bid on $400M sales tax revenue bonds; NR/AAA/AA+:

Pricing Notes: Competitive sale totaled over $1 billion, on a week of elevated secondary selling pressure.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	0.89	+7
2026	5.00	1.66	+9
2031	5.00	2.07	+13

Secondary Trading: On Friday, several maturities traded 2 to 3 basis points weaker than originals.

Pennsylvania Turnpike Commission

9/22: **Goldman, Sachs & Co.** priced $255M turnpike subordinate revenue refunding bonds; A3/NR/A-; callable at par in 12/1/2026:

Pricing Notes: The spot maturities that were bumped to lower yields on institutional re-price was 2026 (lower by 1bp) and 2041 with a 3.375 coupon (lower by 3bps).

Maturity	Coupon	Yield	+/- AAA 5%
2026	5.00	2.33	+76
2036pc	5.00	3.03	+83
2041	3.375	3.50	+115

Secondary Trading: On Monday, the 2041 bonds with a 3.375% coupon traded 2 basis points firmer than originals.