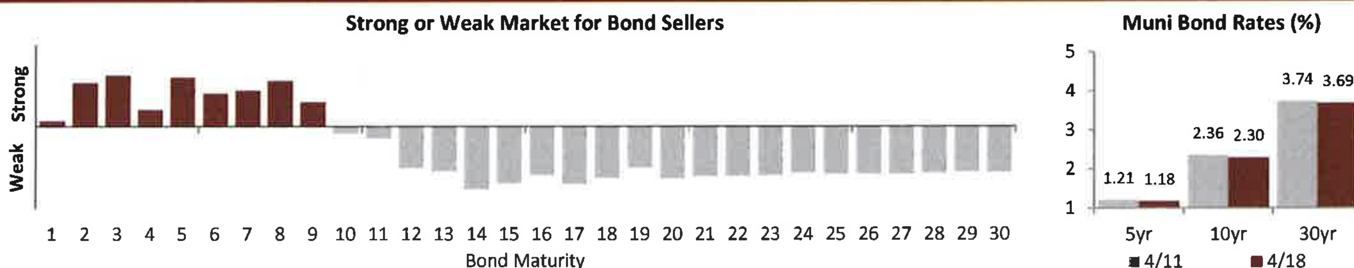
MMA The Power of Independence

APRIL 21, 2014

MUNICIPAL ISSUER BRIEF



Heading into this week, the rally for bonds maturing outside of 10 years that started two weeks ago continued at the start of the week but began to wane so that the longer maturities of the yield curve reflected less pricing power as designated by the "weak" columns. High demand continues to shorter maturities.

MARKET UPDATE

MUNICIPAL RATES WITHSTAND OTHER WEAKER MARKETS: On Thursday last week, most bond markets began to decline significantly, which the municipal market largely ignored. Municipals *outperforming* other markets has been a major theme in 2014.

INVESTORS & ISSUERS: An uptick in supply is scheduled this week.

- **Issuance is the largest it has been in 5 weeks.** Last week's light calendar of deals helped municipal borrowing rates fall to their lowest levels since the end of last summer.
- **These low rates may be untenable in the near-term** as at the end of last week, most bond markets corrected to higher yields as the Ukraine crisis moved toward an initial resolution.
- Municipal rates did not move higher at the end of last week, which **may put pressure to correct to higher yields this week.**
- Once again, a large number of triple-A issuers sold bonds competitively to strong dealer bids, **which helped drive yields for all municipal bonds lower**. These deals traded slightly cheaper in the secondary, which indicated that dealers were initially aggressively stockpiling bonds, but subsequent transactions suggested pressure on triple-A benchmarks to cheaper yields in the near term. **See page 3** for more on regional deals.
- Last week, **MIB** noted that New Jersey bonds, a state recently downgraded, actually traded to higher prices despite the rating change. This week another issuer from the state will come to market—**this will provide a better opportunity to gauge investors' perception of the state's creditworthiness.**
- California and Illinois are testing the market for a second time this year with large GO issuances. **Both states have performed well in secondary markets of late**.
- **Better-rated, higher-education issuers continue to do well in the current market context.** Skidmore College (NY) benefitted last week. However, lower-rated colleges continue to struggle.

TREASURY DEPARTMENT CREATES NEW OFFICE: The U.S. Treasury Department hired a veteran public finance banker to lead a new unit that will broadly monitor the municipal market. As first reported by the *Wall Street Journal*, the Treasury Department hired **Kent Hiteshew**, who previously was a public finance banker at JPMorgan. He will start in May and his unit will focus broadly on the market, budgets, pensions, tax policy and distressed issuers. The Treasury has always had staff following the market but this new office places public finance at a higher status within the Administration.

BUYERS BITES:

WHAT IS TRENDING HOT:

1) New Jersey GO, appropriation-backed bonds
2) Illinois, California GO
3) Stable higher education issuers
4) Bonds with 5- to 8-year call options

CURRENTLY HARDER SELLS:

1) Lower-rated higher education
2) Puerto Rico

WHO IS REPORTEDLY BUYING:

Large banks, separately managed accounts, high-yield mutual funds

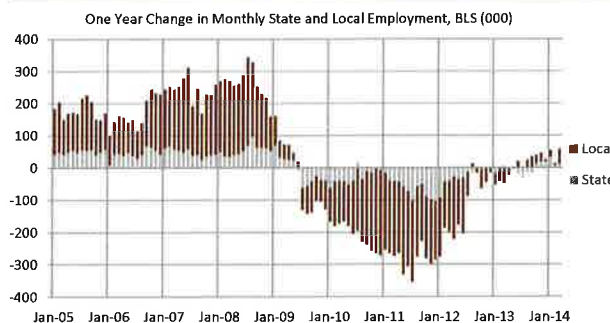


Figure 1: *The chart above looks at the 12-month change in state and local government hiring. Hiring has turned positive, as state and local governments move beyond the financial crisis that began in 2008. The increase has come predominantly from local education hiring. While the reduced job loss is positive, employment trends are not yet positive enough to imply that governments have the resources to begin investing more in infrastructure through bond markets. **MMA** looks at this topic and makes several projections in this week's **Topic of the Week** on* ***Page 2***.

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TOPIC OF THE WEEK: LOOKING AT THE FUTURE

PROJECTIONS: With the municipal market into the second quarter, **MMA** makes three projections for the next 6 to 12 months:

1) Municipal defaults and bankruptcies will remain rare and isolated events;
2) Most issuer credit quality will continue to improve, as real estate values stabilize and tax collections continue to rise; and
3) Price and liquidity performance will be modestly negative. Longer-term, **MMA** expects the municipal market to outperform other taxable fixed income markets, but yields will still rise as the national economy recovers.

Still, systemic risks to the industry exist. Three concerns over a longer horizon are:

1) Policymakers at the federal level continue to contemplate changes—tax reform, restrictions on PABs, new Build America Bonds—that could damage the tax-exemption, the market at large or segments of it. **MMA** still believes the risk of, damage to, or dilution of the tax-exemption is substantially elevated (about 50%) over the next 5 years.
2) Without deep secondary liquidity or effective hedging mechanisms for market participants, we expect many municipal market broker-dealers to continue hold fewer municipal bonds. With dealers holding less municipal bonds, market volatility will be more dramatic. As a result, exacerbated rate shocks are apt to become more frequent as all markets undergo the transition to a non-Federal Reserve influenced marketplace.
3) Low issuance (**Figure 2, below**) and increased regulation is pressuring the revenue models of sell-side firms (broker-dealers, municipal advisors and bond counsels). **MMA** tracks state and local employment trends (**Figure 1** on **page 1**) as a leading indicator of government reinvestment in infrastructure and thus potential new-issue supply. Employment is much less than in recent years. While the trend is slowly improving, it is not yet positive enough to expect governments to have the confidence to commit more resources toward infrastructure through the bond market.

There are other systemic risks that are developing related to cities and states budgets (Detroit, Puerto Rico), long-term obligations (pensions and OPEB), and future forces (climate change). These topics will represent an ongoing series through 3Q.

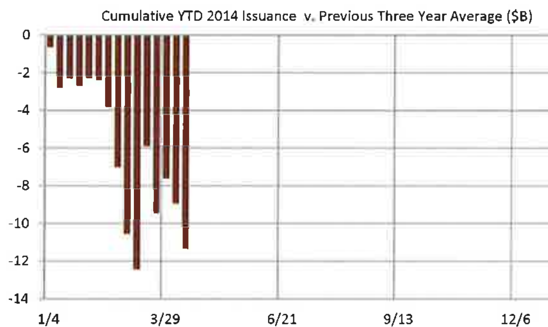

Figure 2: *Issuance remains well below recent averages*

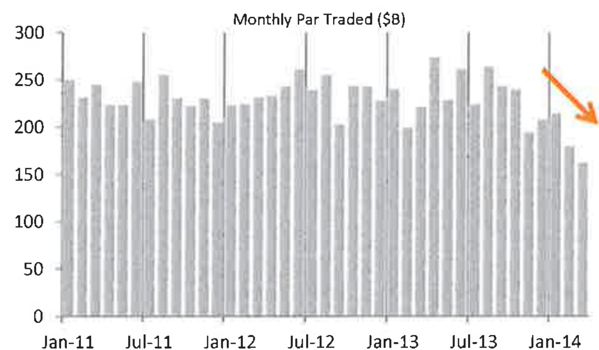

Figure 3: *Secondary trading is on the decline so far this year.*

WHAT THIS MEANS FOR YOU: In the near-term projections, low defaults and broader credit quality improvement is a positive for your borrowing rates. **MIB** will continue to monitor these trends, analyze them and illustrate them to help issuers convey these attributes to potential investors. Next, we expect interest rates to rise this year. Most had anticipated a rate rise in 1Q, but international events and slower economic growth have kept rates low. Issuers have an opportunity to take advantage of the current favorable borrowing rates. Still, **MMA** expects tax-exempt yields to rise, however at a slower pace than taxable ones. Issuers can tap into non-traditional investors (i.e. total rate of return funds, hedge funds) who are apt to seek municipal bonds to outperform other fixed-income investments.

Turning to the longer-term systemic risks: policymakers in Washington have their eye on the cost of the exemption to the Federal Government. Issuer advocacy groups are the most important lobbying effort regarding the exemption. Next, less secondary liquidity (**Figure 3, above**) is important because if your bonds do not trade regularly, investors will demand a premium before buying your bonds in the primary. Finally, many of the new Federal regulations being put in place are not yet final. The intent of much of it is to protect the issuer and to protect the end-investors. Interaction with all parties is key at this time to help to ensure new rules benefit the entire issuer community, while also not being so cumbersome as to discourage investment banks to commit capital to the municipal sector.

REGIONAL BOND ISSUES (Moody's/S&P/Fitch)

NORTHEAST

On April 16th, **Jefferies LLC** priced $69 million of St. Joseph's Hospital Health Center Project revenue bonds for the **Onondaga Civic Development Corporation, New York**; Ba2/BB/A; callable in 7/1/2019:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	4.375	+319
2025	5.00	5.00	+253
2031	5.25	5.375	+217

Notes: This high-yield issue was well oversubscribed.

MID-ATLANTIC

On April 15th, the **Washington Suburban Sanitation District of Maryland** sold $150 million of general obligation refunding bonds to **Citigroup Global Markets Inc.**; Aaa/AAA/AAA; callable in 6/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.14	-6
2024	4.00	2.38	+2
2044	4.00	3.76	+3

Notes: Triple-A and priced on a holiday week sparked big demand

MIDWEST

On April 15th, **Mesirow Financial Inc.** priced $3.1 million of limited tax general obligation bonds for **Dupage County School District, Illinois**; Aa2/NR/NR/; callable at par in 1/1/2022:

Maturity	Coupon	Yield	+/- AAA 5%
2028	3.125	3.125	+79
2033	3.65	3.70	+97
2034	3.70	3.75	+64

Notes: Local IL GOs have not been affected by state's pension woes.

SOUTHEAST

On April 16th, **North Carolina** sold $321 million of general obligation bonds to **Morgan Stanley & Co. LLC**; Aaa/AAA/AAA; not callable:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.33	+6
2024	4.00	2.54	+9
2029	4.00	3.23	+10

Notes: This deal moved the entire short end of the market better

SOUTHWEST

On April 16th, **Jefferies LLC** priced $4.62 million of Williamsburg Public Improvement special assessment revenue bonds for the **City of Fate, Texas**; NR/NR/NR; callable in 8/15/2022:

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	4.00	+283
2023	4.30	4.30	+213
2043	5.50	5.50	+184

Notes: Even without ratings the city received attractive rates.

FARWEST

On April 15th, the **Jordan School District, Utah** sold $107 million of general obligation bonds to **Morgan Stanley & Co. LLC**; Aaa/NR/AAA; not callable:

Maturity	Coupon	Yield	+/- AAA 5%
2015	5.00	0.15	-5
2019	5.00	1.16	-4
2022	5.00	1.97	-7

Notes: Short-maturing competitive deals saw strong bids last week.

RATINGS AGENCY NEWS

MOODY'S ON CORPORATE VS. PUBLIC PENSIONS: Moody's Investors Service recently released a report on corporate versus public pensions, finding that corporate risk is better controlled than municipal pension risk. The report, *Divergent Pension Risks: US Corporates Will Remain in Far Better Position than State and Local Governments,* claims that the unfunded pension liabilities for municipal pensions that fund mostly defined benefits plans rests between 49%-73%, while it stands at 24% for corporates, which since the 1980s have mainly switched to defined contribution plans.

The report noted that municipals lack external incentives to adequately fund future liabilities, since they do not have to answer to shareholders (although one would argue they do have to answer to their citizens), and having to deal with more unionized labor force than the corporate sector. However, the report noted that in general, governments will manage their pension risk over time, and government credit quality is higher than corporates because of credit strengths including: ability to levy taxes and mandatory fees, lack of competition, more predictable revenues and spending, generally lower leverage, conservative debt structures (such as fixed rate amortizing debt) and little or no short-term refinancing needs.

FITCH DOWNGRADES OUTNUMBER UPGRADES: Fitch Ratings last week released a report that noted for the 21st consecutive quarter, rating downgrades outnumbered upgrades, though downgrades still accounted for a small percentage of total public finance rating actions. Fitch downgraded 37 credits, about 5.2% of all rating actions and $51 billion in par value. In 4Q13, Fitch downgraded 25 issuers, and upgraded 21, which represented 3% of all rating actions and $2 billion in par value. In 4Q13, the agency upgraded 23 credits.