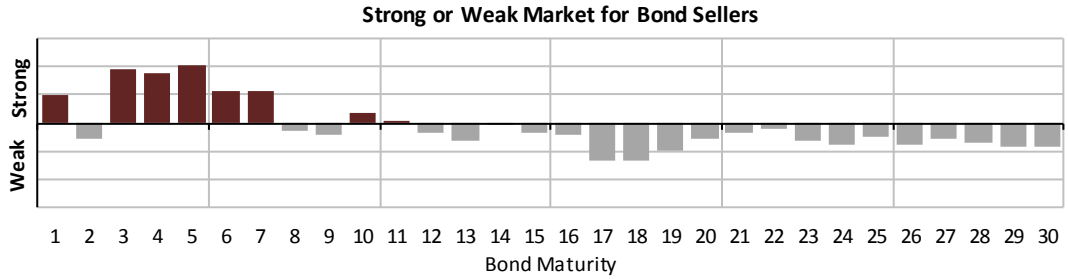
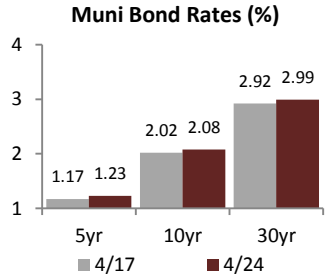
MMA Independent & Data Driven

APRIL 27, 2015

MUNICIPAL ISSUER BRIEF





Heading into this week, the continued weakness has placed more value along the curve than evident in recent weeks. Much of the curve remains in a weak dynamic, especially in the longer maturities. The most aggressive pricing context is in shorter maturities (positive columns).

MARKET UPDATE

CHALLENGING WEEK ENDS ON A POSITIVE NOTE: After struggling through most of the week with several negative dynamics at play, municipal bonds received some breathing room on Friday which may signal stability in the near-term.

INVESTORS & ISSUERS: Several deals struggled last week:

- The big new-issue calendar last week put **many issuers on the defensive.** While issuers still borrowed at near historically low rates, several syndicates were forced to cheapen levels as broader negative conditions persisted.
- Of the noted conditions: large supply for most of the year continued to put the supply/demand dynamic in favor of investors (see **Figure 1**, right); **dealers continued to hold the largest amount of bonds in at least 2 years**, mutual funds again saw investors exit the municipal space; and, Treasury bonds, which generally correlate with municipals, were weaker for most of the week.
- One bright spot was aggressive bidding by two underwriters on California's nearly $1 billion GO sale (see **page 4** for more).
- Additionally, the Chicago Board of Education was able to place nearly $300 million longer-dated bonds in the wake of downgrades and a Federal probe into the Board's CEO. Investors in this deal were **largely non-traditional municipal buyers** or purely trading accounts, meaning we expect these bonds to eventually trade out of these initial purchasers.
- Looking ahead to this week, **supply takes a big drop** to the lowest weekly total since the start of the year.
- This made for a positive backdrop on Friday last week, and put in motion a positive tone heading into month-end.
- Look for the Massachusetts' competitive GO issue on Tuesday to **reveal a measure of market demand**.

FED (MAYBE) MAKES MUNICIPALS HQLA: The *Wall Street Journal* last week wrote that the Federal Reserve may loosen its position and allow some municipal bonds to be considered high-quality liquid assets (HQLA) under banks' liquidity coverage ratio (LCR) as directed by new global banking regulations. It is unclear whether the other two regulators, OCC and the FDIC, would add municipals. The Fed's changed position comes after a lot of lobbying by state and local government groups as well as dealers. It is still unclear which parts of the municipal market would be eligible for HQLA treatment, which for those issuers not included, they could see borrowing costs rise. For more on HQLA and what it means for you, see this **MIB** from October.

BUYERS BITES:

WHAT IS TRENDING HOT:
1) Chicago schools rallying since issuance
2) California GO

CURRENTLY HARDER SELLS:
2) Longer-dated maturities
2) 4% coupons or lower underperformed 5% coupons

WHO IS REPORTEDLY BUYING:
Insurance companies, trading accounts, SMAs

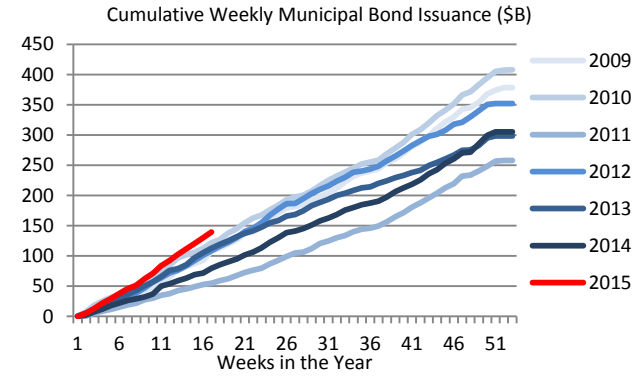


***Figure 1**: Issuance in 2015 (red line above) has surpassed every year through the first 17 weeks of the year, going back to at least 2009. Refundings have driven the large amount of issuance, which are largely interest-rate dependent. This week will see the lowest amount of issuance since the start of January. This has provided a positive backdrop for the market, and should give dealers some breathing room after being weighed down with the most amount of bonds on their balances sheets in 2-years, according to Federal Reserve data.*

TOPIC OF THE WEEK: SUPERDOWNGRADES

SUPERDOWNGRADES: As we suggested in January of 2014, municipal bond superdowngrades (a credit downgrade of 3 notches or more) declined last year and have continued to do so in the first quarter of 2015. In the time immediately after the financial crisis first began 6 years ago, the level of these disruptive actions increased as the economic tailspin took a toll on state and local governments. Superdowngrades were also on the rise in part because the rating agencies themselves shifted their methodologies when analyzing a municipal credit and at times new factors were weighed more heavily that led to these large credit swings. The latest shift to less of these actions (now down 55% from the height in 2012) suggests less unexpected, ratings-related price volatility and perhaps a slowing of anxiety inducing criteria changes. Going forward, **MMA** expects that these actions will 1) continue to be on the decline over the next 12 months; 2) be focused on troubled issuers and those in risker housing, healthcare and school district sectors and 3) issuers that are subject to unusual circumstances. As for the last point, "unusual circumstances" come in the form of the latest budget from Illinois. In it, the governor proposes to halve the percentage of state income tax revenues provided as aid to local governments. If enacted, this would be the kind of event to trigger superdowngrades, but **MMA** considers such an event as unlikely as there is no precedent for such action in the state and rarely have such actions occurred in other states.

WHAT THIS MEANS FOR YOU: Fewer superdowngrades is a positive for all municipal issuers as these actions undermine investor confidence in the sector as well as the rating agencies themselves. Perhaps the most important development that may affect these types of actions are new rules regarding issuer accounting standards. These include criteria updates focused on improving other post-employment benefit liabilities on issuer balance sheets. The potential for them to be considered debt-like in bankruptcy may alter the way rating agencies view issuer liabilities that could in theory raise the level of superdowngrade activity. While fewer superdowngrades is a positive, there are lessons to be learned from those that are still seeing these large credit actions. So far in 2015, nearly one-third of the governmental superdowngrades were related to Puerto Rico, Atlantic City, NJ and Wayne County, MI. These issuers have been on the market's radar screen for some time, so the surprise factor has diminished considerably as the fiscal health of these entities has been worsening for an extended period of time. This accelerated slide is not uncommon for governments with long-term fundamental challenges. In sum, troubled credits fall harder and faster. Among the remaining superdowngraded issuers, most have been school districts. In many, rising pension costs and high debt burdens were present. However, there were also several idiosyncratic factors that played a role in the actions such as budgeting mistakes, lack of support for new operating levy, use of debt service money as operational liquidity or charter school competition. Schools in Michigan and Illinois accounted for 13% of all superdowngrades in 2015—in large part because of state level fiscal challenges.

TAX REFORM LETTERS

MUNICIPAL GROUPS TO SENATE FINANCE: KEEP THE EXEMPTION: As the Senate Finance Committee continues its internal discussions on tax reform, groups and individuals were invited to submit comments for the Committee and its working groups to review. **Numerous municipal groups, including issuers, bankers and lawyers, submitted comments extolling the need to keep the exemption on municipal bond interest**. All of the comments carried a similar theme: tax-exempt bonds have been the backbone of providing for the country's infrastructure needs, and without them, costs to provide vital services and infrastructure for communities and taxpayers will increase.

Large issuer groups, including the National Association of Counties (NACo) and the US Conference of Mayors, along with the Government Finance Officers Association (GFOA), again covered the importance of maintaining the tax-exemption, and included their 2013 study *Protecting Bonds to Save Infrastructure and Jobs*. Further, the groups also commented on the importance of maintaining the state and local tax deduction, concerns with Congressional initiatives to override state and local tax policies on items such as telecommunications and hotel bookings, and stressed the importance of having Congress pass legislation to mandate the collection of taxes on sales made over the Internet.

A group of issuers, including the National Association of Local Housing Finance Agencies (NALHFA) and Community Development Finance Agencies (CDFA), and other market participants, such as the Bond Dealers of America (BDA) and the National Association of Bond Lawyers (NABL), also strongly advocated for maintaining the tax-exemption stating "there is no better alternative." Their letter also addressed common misperceptions about municipal bonds, including disclosure standards, and the investor base of bonds.

Groups representing **power authorities** focused comments on how changes to the tax code would affect their sector. Their letter supported the need for public power authorities—that provide power to one out of seven Americans—to continue to be able to issue tax-exempt bonds as the most cost effective and efficient manner in which to access capital markets. Their letter goes on to **detail why other proposals—tax-credit bonds, cap on municipal interest, and direct-subsidy bonds—should not be seen as wholesale replacements for tax-exempt bonds**.

Higher Education and Non Profit Health Care Financing Associations submitted a statement to the Committee calling on Congress to "protect tax-exempt bond financing, including qualified 501(c) (3) private-activity bonds, which is necessary for the continued financial health of hospitals, colleges, universities and other charitable organizations."

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

- **Last week three large deals influenced the general market (highlighted in yellow below):**
- The **Chicago Board of Education**—plagued with many negative headlines—was able to come to market at the borrowing rates its syndicate had initially suggested well before pricing. While the interest rates were quite high (as much as 275 basis points higher than prevailing AAA rates) there were non-traditional investors that lent the issuer needed dollars.
- **Miami-Dade County's** $350 million offering struggled last week, and eventually had to increase yields by as much as 22 basis points. These troubles crystallized the difficult environment for issuers last week.
- **California** competitively sold nearly $1 billion tax-exempt general obligation bonds in two series to two different underwriters. The bidding was aggressive and well through the **MMA California GO Benchmark**. The bonds traded cheaper in secondary markets later in the week.

NORTHEAST

4/21: The **Tuckahoe Union Free School District, NY** sold $8.6 million general obligation bonds to **Roosevelt & Cross Inc.**; Aa3/NR/NR; callable at par in 7/15/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2015	2.00	0.30	
2020	5.00	1.36	+18
2025	2.125	2.15	+13

Notes: NY-focused dealers can be more aggressive in local SDs

MID-ATLANTIC

4/22: The **Economic Development Authority of Powhatan, VA** sold $22.6 million lease revenue refunding bonds to **Wells Fargo Securities**; Aa3/AA/NR; callable at par in 9/15/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	3.00	1.45	+26
2025	5.00	2.28	+24
2031	3.00	3.24	+74

Notes: Lower coupon payments out long the result of ins company.

MIDWEST

4/21: **PNC Capital Markets LLC** priced $295 million unlimited tax general obligation bonds for the **Chicago Board of Education, IL**; NR/A-/BBB-, Kroll: BBB+; callable at par in 12/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2035	5.25	5.53	+281
2035	6.00	5.38	+266
2039	5.25	5.63	+280

Notes: Premarketing levels ended up being final levels for the issuer

SOUTHEAST

4/23: **RBC Capital Markets** priced $348 million general obligation bonds for **Miami-Dade County, FL**; Aa2/AA/NR; callable at par in 7/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.57	+13
2025	5.00	2.52	+45
2042	5.00	3.48	+52

Notes: The difficult market forced a re-pricing to much higher yields

SOUTHWEST

4/20: **FirstSouthwest** priced $20.7 million general obligation bonds for the **Amarillo Independent School District, TX**; Aa2/AA+/NR; PSF (Aaa/AAA/NR); callable at par in 2/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2030	3.00	3.20	+74
2035	5.00	2.98	+26
2043	5.00	3.12	+21

Notes: PSF-wraps have increased with TX population growth

FARWEST

4/21: **California** sold $579 million general obligation bonds to **Morgan Stanley & Co.**; Aa3/A+/A+; callable at par in 2/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2026	5.00	2.36	+24
2030	5.00	2.73	+27
2035	3.25	3.46	+74

Notes: The 15yr bond was 7bps richer than the MMA CA Benchmark