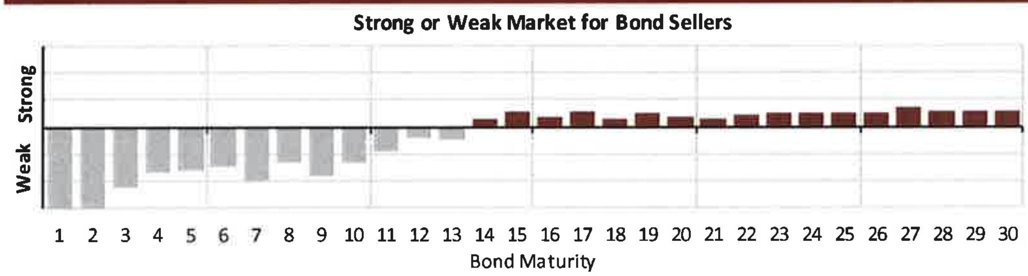
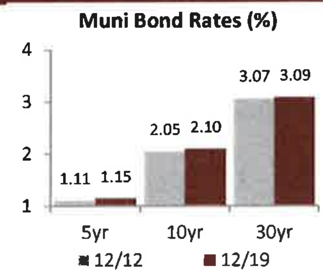
MMA The Power of Independence

DECEMBER 22, 2014

MUNICIPAL ISSUER BRIEF





Heading into this week, a weaker dynamic has developed in the short and intermediate portions of the yield curve, as taxable losses last week put upward pressure on yields. However, issuers still have an opportunity as the market context suggests a stronger pricing dynamic for longer maturities.

MARKET UPDATE

A POSITIVE BIAS INTERRUPTED: The Federal Reserve focused on the silver linings in the slow economic recovery and indicated an adjustment in its monetary policy next year. As a result, domestic bond markets were hit hard last Wednesday and Thursday.

INVESTORS & ISSUERS: A taxable sell-off sparked municipal weakness

- After hovering near the lowest yields of the year, **U.S. bond markets lost significant ground last week** as investors began to assume that the Federal funds target rate would rise next year.
- **Tax-exempt yields were forced higher**, as well, despite starting the week with a constructive tone.
- Last week effectively concluded 2014 issuance. New-issues generally did well **as the bulk of the deals preceded the negative volatile market conditions at week's end**.
- Namely, **NY Dorm Authority**, the **Arizona Transportation Board** and the School **Board of Miami-Dade County** all priced on Tuesday and were able to re-price to lower yields. See **page 3** for more on regional deals.
- Even as bond markets began to sell-off, a few large asset managers aggressively began to buy high-grade and more liquid GOs out of CA, PA and NYC. **Their impact helped longer maturities perform better in the challenging marketplace.**
- This, along with municipal bond mutual funds experiencing positive flows, made for **positive elements heading into the year-end** and the start of 2015 (see **Figure 1**, right)
- Issuance this year will likely end up just below the 2013 total and **MMA** expects slightly higher issuance in 2015. The supply/demand balance should remain favorable for issuers next year.
- Still, if the Federal Reserve changes its target rate, interest rates could rise and **issuers will need to be sensitive to changing market conditions when accessing the capital markets.**
- ***Merry Christmas and cheers to a happy and healthy 2015.***

MCDC PROPELS FILINGS: December started with the busiest week of municipal impairment filings on record (54), surpassing the first weeks in July 2009, when **MMA** first started collecting data. (54 is roughly double the weekly average of about 20-25 total filings). Further, **MMA** added 11 and 9 new credits to the database, respectively, during the first two weeks of December: both well above the current rolling weekly average of 3.7 additions. This pushes the YTD count of cumulative additions to the database to 177: a 21% jump over last year. See **page 2** for more trends in 2014.

BUYERS BITES:

WHAT IS TRENDING HOT:
1) New York City issuers
2) Healthcare, Higher Education

CURRENTLY HARDER SELLS:
1) 3.5% and 4% coupons in the 11-20 year range
2) IG toll revenue bonds
3) Puerto Rico

WHO IS REPORTEDLY BUYING:
Mutual funds, institutional asset managers, large banks

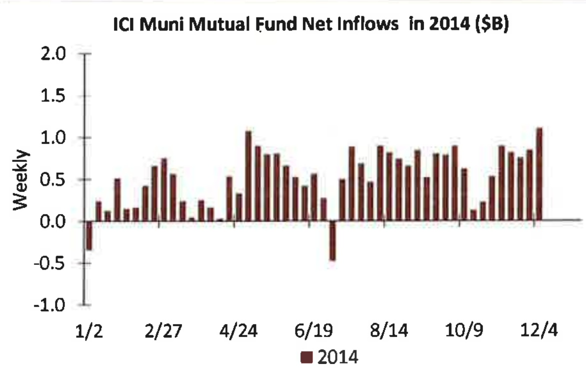


***Figure 1**: After a challenging 2013 for mutual funds that purchase municipal bonds, this year was a decidedly positive with only 2 weeks seeing net less cash going into the funds. The chart above tracks the amount of cash going into the funds on a week by week basis. The latest few weeks have seen an increase in cash going into funds meaning mutual funds have been more active in the marketplace and helping to digest the last few weeks of above-average issuance.*

TOPIC OF THE WEEK: IMPORTANT ISSUES IN 2014

Tax-Exemption Threats Continue: Although the tax-exempt market finances two-thirds to three-quarters of the nation's public infrastructure, the tax-exemption itself remains on the attack by both left- and right-leaners in Washington, DC. In the area of "infrastructure" generally, public private partnerships (P3s) (which have provided just 1.5% of highway funding since 1989) have become a more fashionable topic for discussion. Risks of sweeping tax reform are low in the near term, but **there remains greater potential for the exemption to be compromised to pay for another one-off policy in the future.**

Regulatory Eyes on the Market: Financial regulators have increasingly focused on making the market work better for municipal investors. Several new initiatives to provide more reliable and solvent trading markets, improved pre- and post-trade transparency, and better and more trustworthy issuer disclosure practices have emerged. **New protections for issuers in the Municipal Advisor rule have increased the regulatory burdens for both municipal advisors and underwriters, which will likely result in higher debt issuance costs for issuers**. The increased SEC focus on issuer disclosure practices through the MCDC initiative is also quite noteworthy. We see this trend continuing in 2015.

States' Fiscal Health: There is no single message takeaway in this area for 2014. For example, CA took positive steps to improve its condition and NJ made a bad situation worse. Exuberance over CA's fiscal and rating improvements led the state's securities to outperform the market for a second year. In NJ, lagging economic performance and budget practices that optimistically project revenues while failing to address mandates such as funding pensions, OPEBs, and transportation with recurring revenues has led to a persistent structural imbalance and a deteriorating fiscal position.

Pensions: Pension health and funding issues drove headlines and rating changes in 2014. Years of below-required employer funding and investment losses resulted in asset growth that trailed liability increases, widening the funding gap. Many governments have improved funding during the economic recovery, but others have lagged. Several states and local governments have tried to reform pensions with varying degrees of difficulty and almost never without a legal battle. **Pension funding will remain a critical credit issue in 2015 as the GASB accounting changes become more visible and rating agencies continue to stress the importance of this factor in rating decisions**.

GO Strength Damaged: **Detroit and Stockton bankruptcies have damaged confidence in and the strength of municipal security pledges for general obligation bonds.** Even though the majority of sub-par settlements for municipal creditors were consensual, they imply that the affected municipal security pledges offer little protection in Chapter 9. Investors can no longer have confidence in the bankruptcy-recognized position of their security in the capital structure, absent a statutory lien. Main bondholder takeaways from the bankruptcies include: 1) pensions' (effective) seniority to unsecured GO bondholders; 2) potential lack of distinction or better treatment for unsecured bonds vs. OPEB obligations in Chapter 9; and 3) unclear level of insulation from the effects of Chapter 9 for "special revenues."

Issuance Levels Remain Low: Despite near record low yields and generous acceptance of weak credits, 2014 new-issue supply is likely to finish at just less than $325B, and the Federal Reserve shows a 1.1% contraction in the amount of outstanding municipal bonds through three quarters of 2014. As a result in the near-term, this means that **issuers will continue to benefit from a favorable supply/demand imbalance that heavily favors sellers**. For the longer-term it means that important infrastructure is not being developed or maintained. This is in part because of a difficult political climate in which to borrow that is magnified with an increased focus on pension costs and a slow recovery pace of the US economy. We see only limited growth in new project funding in the next several years.

Defaults Falling: Despite continued concerns that more local governments would become distressed as costs increase faster than revenues, 2014 wasn't that year. **Since Detroit, almost 18 months ago, no traditional local government has filed for Chapter 9 bankruptcy protection**. Across the market—safe and risky sectors—the number of first-time defaulters is declining. Investors should not ignore a dominant, countervailing trend: despite the major credit pressures placed on issuers in the last decade, the current general obligation default rate is still just 0.03%. In other words, the public sector has shown extraordinary credit resilience during the arguably worst economic scenario since the Great Depression.

Bond Buyers: Overall, after a decade of more issuance and growth in the market, the last few years has been much more mixed. This benefits issuers who are competing for investor attention. Who were these investors this year? **Individual investors have shifted into more professionally managed investment accounts (separately managed accounts, SMAs) and similarly, mutual funds have returned as a more positive investor for issuers, as assets continue to grow and cash has to be invested into municipal bonds**. As **MMA** has noted all year, banks are slowing their investments into municipal bonds and this could present a challenge for large, high-grade issuers in which the bigger banks have tended to invest. Finally, international buyers and insurance companies look at municipal bonds as part of their total rate of return strategies and thus tend to compare municipals on a taxable equivalent basis to other fixed-income alternatives.

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

NORTHEAST

12/18: **Citigroup Global Markets Inc.** priced $29M MassDirect general obligation bonds for **Massachusetts**; Aa1/AA+/AA+; not callable:

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	1.12	+1
2024	5.00	2.09	+5
2025	5.00	2.18	+5

Notes: Massachusetts markets bonds directly to retail investors

MID-ATLANTIC

12/17: **Piper Jaffray & Co.** priced $6M water revenue bonds for the **Plum Boro Municipal Authority, Pennsylvania**; NR/AA/NR; callable in 11/15/2019:

Maturity	Coupon	Yield	+/- AAA 5%
2034	4.00	3.05	+24
2039	3.70	3.85	+87
2040	4.00	3.55	+55

Notes: Sub-5% coupons were effective even for longer-dated bonds

MIDWEST

12/16: **Jefferies LLC.** priced $137M water pollution control loan fund refunding revenue bonds for **Ohio Water Development Authority;** Aaa/AAA/NR; non-callable:

Maturity	Coupon	Yield	+/- AAA 5%
2018	5.00	1.03	+18
2019	5.00	1.30	+19
2022	5.00	1.94	+13

Notes: Deal was well received despite a tougher short end of late

SOUTHEAST

12/18: **Raymond James & Associates** priced $29M unlimited tax general obligation bonds for **Henry County, Georgia**; Aa1/NR/NR; not callable:

Maturity	Coupon	Yield	+/- AAA 5%
2015	3.00	0.37	+21
2019	5.00	1.21	+11
2020	5.00	1.55	+16

Notes: Another short deal that fared well despite challenges

SOUTHWEST

12/18: **BOSC, Inc.** priced $98M unlimited tax refunding bonds for the **San Angelo ISD, Tom Green County, Texas**; NR/AA-/AA; PSF guaranteed; callable in 2/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	1.29	+18
2024	5.00	2.26	+22
2034	4.00	3.38	+56

Notes: Deal priced on a market sell-off day and had to raise yields

FARWEST

12/15: **Siebert Brandford Shank & Co.** priced $229M power system revenue bonds for **Los Angeles Department of Water and Power**; Aa3/AA-/AA-; callable in 7/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.07	-4
2024	5.00	2.03	-2
2044	5.00	3.13	+6

Notes: These yields were low for the rating showing demand