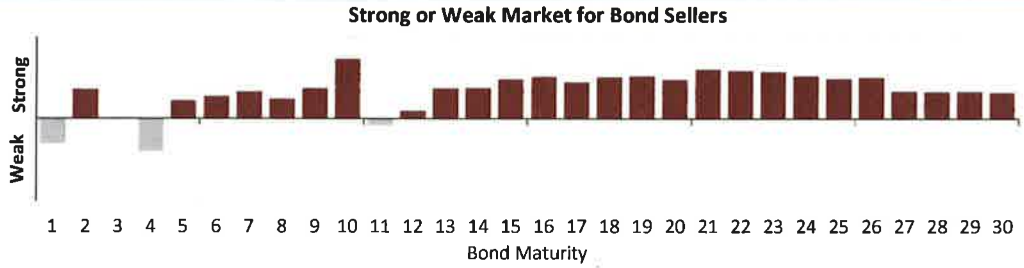
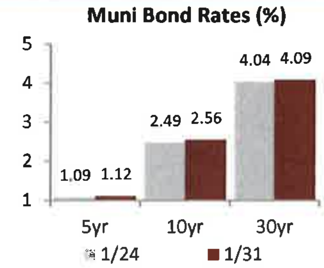
MMA The Power of Independence

FEBRUARY 3, 2014

MUNICIPAL ISSUER BRIEF





Heading into this week, the positive dynamic established over the previous 2 weeks continues with the most consistent strong pricing evident for bonds maturing 13-years and longer. Still, compared to last week the pause in the January rally and volatility have tempered some of the immediate demand for the longest maturities.

MARKET UPDATE

THE JANUARY RALLY STALLS: The municipal market's advance paused in the middle of last week and ended the month's rally of consistent gains. This occurred even with some very favorable themes still in tact for the market, which is somewhat troubling.

INVESTORS & ISSUERS: The market slowed down considerably.

- **The municipal market lost ground last week.** The losses were surprising as other bond markets continued to post gains.
- **The supply picture is still favorable for issuers.** This January saw one-third fewer bonds issued compared to 2013 and this week continues that trend into February, which in theory will help keep rates low.
- Adding to the favorable conditions is that **mutual funds that buy municipal bonds added investors** for the 3rd straight week.
- That the tax-exempt municipal interest rates still rose in light of these theoretically favorable developments **starts this week on somewhat tenuous ground** .
- **The state of Illinois will sell $1 billion of general obligation bonds this week.** When the state last came to market its bonds traded as much as 35 basis points richer in just the day after it sold. This subsequent performance was due to the firm market conditions at the time while the initial pricing was indicative of the distribution challenges for underwriters. Read more about dealer's involvement in the market on **page 3.**
- **A few insurance companies are making big plays** in the market for longer-dated maturities. Issuers can take advantage of this.
- **California GO yields rose** faster than the rest of the market.
- **Widely held Puerto Rico bonds began to trade cheaper** after it was removed from some S&P indexes and as speculation continued as to whether it can sell bonds in the next 3 weeks or will be downgraded.

STATE OF THE UNION: President Obama's State of the Union speech was light on specifics regarding state and local governments and the municipal market. The President gave a nod to private investment, and **MMA** expects to see in his fiscal 2015 budget proposal another push for a public-private partnership and the development of a National Infrastructure Bank for state and local government projects. Some sort of Build America Bond-style program is also likely to be part of the proposal.

BUYER BITES:

WHAT IS TRENDING HOT:
1) Bonds maturing in 3- to 5-year range
2) Short-call structure

CURRENTLY HARDER SELLS:
1) Longer maturities performed the worst last week
2) California GO
3) Puerto Rico

WHO IS REPORTEDLY BUYING:
Large banks, life insurance companies

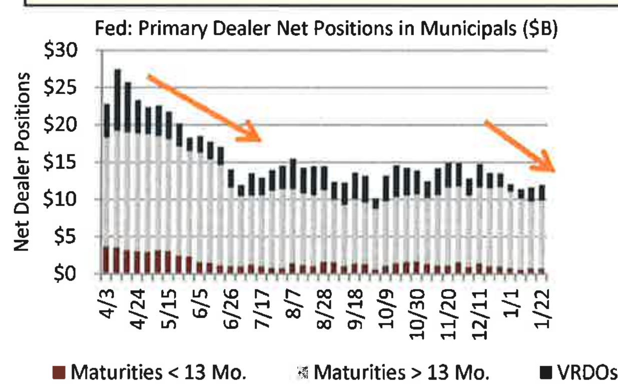


Figure 1: *The Federal Reserve Bank of New York reports the amount of municipal bonds that dealers are holding on a week-by-week basis. Since April of last year, the amount of dealer holdings has dropped considerably, which exacerbated the volatility of last Summer. We note that dealers are again shrinking their municipal holding into 2014, which could be a negative development. We discuss dealer positions in the market place in this week's **Topic of the Week** on **Page 3.***

TOPIC OF THE WEEK: SHRINKING DEALER POSITIONS

DEALER POSITIONS REMAIN LIGHT: Municipals dealers, in general, are holding fewer municipal bonds in their inventories than previous years. While this trend started in in April last year, at the end of December and into the start of 2014 their holdings have been on a downward trajectory (see **Figure 1** on **page 1**). The lack of municipal new-issuance in this time frame is clearly a driver for dealers holding fewer bonds, but there are larger, overarching themes that may make it more difficult for dealers to inventory more municipal bonds in the future. A new regulatory regime is being put in place. Recently, the Federal Reserve proposed a new rule that demotes municipal securities into a less liquid category, which means they are deemed less tradable (**see below** for more). This could induce dealers to hold fewer municipal bonds in the year to come. Regulations aside, recent market volatility and less underwriting revenue in general may also reduce dealers incentives to make their capital available to the municipal market.

WHAT THIS MEANS FOR YOU: When municipal underwriters buy, hold and trade fewer municipal bonds it can make it more difficult for an issuer to sell bonds. In theory, a dealer that is intentionally holding fewer bonds is likely to spend more time identifying buyers (which at times can be a cumbersome process). As a result borrowing costs can increase. Putting this theme in a market context also is important. Dealers holding fewer municipals bonds can make the marketplace more volatile, as illiquidity can be more pronounced and price discovery poorer. In essence, dealer's diminished market presence can make for greater yield volatility in borrowing rates that can inhibit clear pricing at the time of bond sale and resistance from investors unsure of price and value.

This January has seen a very strong rally which some issuers have been able to take advantage. One of the many influences of the rally was a general lack of new-issue supply and a demand that outweighed it. Should supply not materialize in February, yields could be pushed downward even more than they are now. If this continues (and dealers do not hold on to more bonds) there is a greater concern that an eventual future correction will be more swift and volatile. This is a broad negative for the market, which relies heavily on individual investors looking for income preservation and minimal volatility.

BANK REGULATIONS, PENSIONS & GFOA WINTER MEETING

LIQUIDITY RULES & BANK INVESTMENT IN MUNICIPALS: The high quality liquid asset (HQLA) rule, which was proposed by the US Office of the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Company, may negatively affect the municipal bond market, Fitch Ratings noted in a release. The proposed rule, for which public comments ended on Friday, would impose new liquidity requirement standards on banks if implemented as currently written. More than 12 national groups representing state and local governments have submitted comments opposed to the proposed rule.

Issuers should pay close attention to the HQLA because, in essence, the new rules would put municipal bonds in a lower tier of liquidity (tradability) in the regulators' eyes. This could encourage banks to purchase fewer municipals bonds or even start to sell some of the bonds they have purchased over the last few years. Year-over-year growth of bank holdings of municipals over the past 3 years grew to more than 20% for the first time since 1985. However, in recent quarters the pace of bank demand has waned.

MOODY'S ON PENSIONS: Moody's Investors Service released a report on state pension liabilities that showed they grew for 38 states in fiscal 2012. The report said that adjusted net pension liabilities (ANPL) widened for most states, with the median ratio of it to government revenue increasing to 64% for fiscal 2012 from 45% in 2011. The 10 states with the largest pension burdens saw increases ranging from 35% to 77%. In aggregate for all states, the ANPL increased 24% to $1.2 trillion in 2012, from $998 billion in 2011. The report, however, noted that fiscal 2012 could be the "cyclical peak" for this trend, given increases in investment returns and interest rates since then.

GFOA WINTER MEETING: The Government Finance Officers Association (GFOA) held its winter meeting in Washington, D.C. last week. A variety of topics were covered, including a discussion of the SEC's Municipal Advisor rule. The GFOA debt committee will update its best practices on hiring municipal advisors and underwriters to reflect the rule.

John Cross, the director of the SEC's municipal securities division, spoke at the meeting and focused his comments around the situation where an issuer has a municipal advisor and uses the MA exemption to allow for broker-dealer advice. Issuers are concerned this means that advice and recommendations must in all cases be shared with the MA, thereby generating increased fees and making it more difficult to supervise their MAs. Cross tried to alleviate these concerns, stating that once the MA relationship is established and therefore the FA exemption is also established, MAs do not need to be present or receive all the underwriter communications. Mr. Cross stated that the issuer remains in charge of the relationship with members of its financing team, even when the issuer affirms to underwriters in writing that it will rely on the advice of the municipal advisor. Cross said that he expects his office to provide further clarification on this point, as issuers, underwriters and MAs are developing appropriate language related to the MA exemption.

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

NORTHEAST

On January 28th, **Raymond James & Associates** priced $360 million of general resolution revenue bonds for the **New York City Municipal Water Finance Authority**; Aa2/AA+/AA+; callable at par in /2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	0.85	-24
2044	4.25	4.39	+35
2047	5.00	4.43	NA

Notes: The longest maturities had to be cheapened to distribute.

MID-ATLANTIC

On January 29th, **Citigroup Global Markets Inc.** priced $155 million of general obligation bonds for **Philadelphia, Pennsylvania;** A2/A+/A-; callable in 1/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.72	+63
2024	5.00	3.37	+88
2034	5.25	4.65	+69

Notes: Recent upgrades boosted institutional demand.

MIDWEST

On January 28th, **Stifel Nicolaus & Co.** priced $50 million of unlimited tax general obligation bonds for **North Ridgeville Schools, Ohio**; Aa3/NR/NR; callable in 12/1/2021:

Maturity	Coupon	Yield	+/- AAA 5%
2019	2.00	1.51	+42
2024	4.00	3.12	+63
2044	5.00	4.35	+30

Notes: The 30-year maturity at +30 bps for this school was strong.

SOUTHEAST

On January 28th, **Wells Fargo Securities** priced $53 million of East Carolina University general revenue bonds for the **University of North Carolina** ; Aa2/AA-/NR; callable in 10/1/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.50	+41
2024	5.00	2.88	+39
2029	5.00	3.56	+29

Notes: Choosing a local but national underwriter benefitted.

SOUTHWEST

On January 29th, **RBC Capital Markets** priced $40 million of general obligation bonds for **Alamo Community College District, Texas**; Aaa/AA+/NR; not callable:

Maturity	Coupon	Yield	+/- AAA 5%
2015	4.00	0.19	0
2019	5.00	1.22	+11
2023	5.00	2.57	+19

Notes: Saw good reception from investors seeking a natural AAA.

NORTHWEST

On January 28th, **Florida Department of Transportation** sold $145 million of revenue bonds to **JPMorgan Securities LLC**; Aa3/AA+/AA; callable at par in 7/1/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.38	+29
2024	5.00	2.84	+35
2043	5.00	4.14	+10

Notes: Timed the market by using an 18-hour window.