MMA Independent and Data Driven

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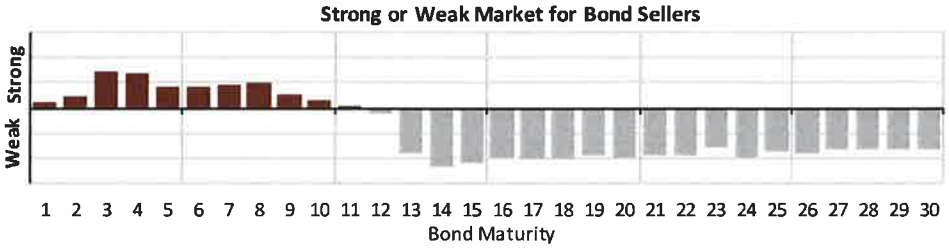
MUNICIPAL MARKET JOURNAL



MMA 5% AAA Benchmark

	1/15/2016	1/8/2016	Change
2-yr	0.64%	0.66%	-2
5-yr	1.13%	1.16%	-3
10-yr	1.84%	1.88%	-4
30-yr	2.79%	2.81%	-2

Stronger demand and stronger prices are typical features of early January in the municipal bond market. At mid-month, more aggressive pricing has appeared inside 10-year on the municipal curve (positive maroon columns), while the longer maturities have tempered their strong start to the year (negative gray columns).

MARKET UPDATE

Municipal's upward price momentum has remained intact (**Figure 1**) but there has emerged increased vulnerability to a correction. Issuers have the most attractive issuing context since January 2009 (**Figure 3**).

HIGHLIGHTS

- Low municipal yields are rubbing against investor ambivalence, preventing the tax-exempt sector from sharing equally in strong US Treasury performance in response to worsening US economic fundamentals (and falling US equity indexes, **Figure 2**), global commodity oversupply issues, and a stumbling China.
- Municipal-to-Treasury ratios rose to their highest marks since just before Christmas (90.4% at the 10yr, 99.2% at the 30yr), reflective of municipals not able to keep pace with the Treasury advance — a directional trend that is apt to continue with the Treasury rally.
- Still, tax-exempt bond prices ended slightly higher along a flatter curve last week. Flattening remains mostly upfront, with the 2s/10s term spread now +120bps, down from +130bps at year end and +157bps at the start of 4Q15. With BBB/AAA credit spreads also holding fairly stable at about +100bps, lower rated issuers still have an opportunity to capture attractive levels of financing.
- It follows that buyers remain engaged in the current market only as forced by reinvestment pressures. Dealers had been actively reducing inventories (in particular for bonds 10yrs and longer) before ratios rose.
- And customer buying activity remained particularly elevated last week, another testament to mutual fund inflows (~$2.5B YTD) and still thin net supply.
- The market is thus carrying performance risks regardless of the interest rate direction: to the extent UST continues to rally and ratios continue to rise, dealers will need to increase turnover via concessionary pricing. Rising taxable yields, by contrast, could see retail demand quickly give way in anticipation of another Fed hike. And, assuming yields stay relatively low and flat, higher new issue supply expectations are likely.
- Finally during the rally of 2016, some investors have been selling into the market strength to satisfy the demand created by the primary issuance void—this occurred similarly in January 2009.

Figure 1: Municipal price performance remained positive in 2016.

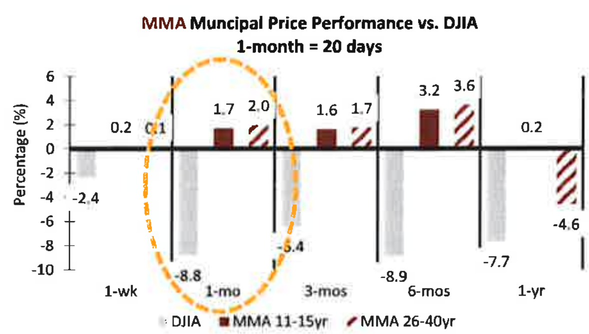


Figure 2: Municipal prices gained > 1.5% as Dow's Index fell -8.8%

Figure 3: MMA's data showed best issuer context since January 2009.

ATLANTIC CITY NJ, CHAPTER 9 BANKRUPTCY, DEFAULT RATES & PUERTO RICO

ATLANTIC CITY REPORT KEEPS CHAPTER 9 RISK ALIVE: Atlantic City remains relevant to municipal investors so long as the state, and its politically opportunistic leadership, considers pushing the city into bankruptcy (and thus exploding the state's excellent reputation for local intervention and bondholder protection). A forced restructuring in Atlantic City would be another blow to investor confidence, not only in NJ but nationwide. The latest developments—the release of a long overdue report on the city—continue to sustain this fear even though bankruptcy no longer appears to be the primary goal. **MMA** believes that there is still a meaningful risk of the city filing for chapter 9 (and thus collateral damage to the prices of all NJ distressed city bonds) over the medium term.

CHAPTER 9 BANKRUPTCY UPDATE: 2016 already has two chapter 9 filers, although they look very much like last year's filers: tiny special districts: **Southern Inyo Healthcare District** in CA and **Washington County Sanitary Improvement District 10** in NE .

PUERTO RICO GETS MORE REALISTIC: Puerto Rico released a dramatic revision to its four-month-old Fiscal and Economic Growth Plan (FEGP), greatly increasing projected deficits and extending the projection period from five years to ten. In short, wider budget gaps reflect weak year-to-date revenue collections (the commonwealth having cut expected FY16 revenues by $500M or 5% in December), a more conservative view of economic growth prospects, and higher spending to accelerate the reduction in accounts payable to local taxpayers, businesses, and stakeholders. Further, GDB President Acosta has also been quoted saying that GO debt service due in the spring is not payable. **MMA's** takeaways here are minimal because, although the new numbers are worse than before, financial disappointment in PR's cash flow was always going to be the case.

MUNICIPAL SECTOR-LEVEL DEFAULT RATES IMPROVE: Away from the noise of Puerto Rico, the CUSIP-based sector-level default rates for most municipal sectors on 1/1/16 were slightly better, on average, than in 3Q15. In general, default rates are extremely low for 9 of the 10 largest municipal sectors. Best improvement overall was retirement projects, where the default rate fell by 0.73% to 4.98%. This is a notable as it shows how the pace of default resolution is slightly outstripping the still elevated rate of new retirement projects falling into trouble. Sectors seeing rising default rates include IDBs (up 0.18% to 2.33%), TIF/TABs (up 0.16% to 2.03%), local multifamily housing (up 0.12% to 1.70%), and charter schools (up 0.10% to 1.76%).

IMPACTFUL BOND DEALS AND ASSOCIATED TRADING

***Below** are __four__ new primary deals that have impacted the market recently with associated secondary trading dynamics:*

Chicago, IL

1/12: **Citigroup Global Markets Inc.** priced $500M general obligation refunding bonds for **Chicago, IL**; NR/BBB+/BBB+, Kroll: A-; callable at par in 1/1/2026:

Pricing Notes: Bonds were bumped 4 to 5 basis points across the curve as several other large new issues also adjusted to lower yields.

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	3.53	+248
2026	5.00	4.31	+241
2038	5.00	4.88	+220

Secondary Trading: The day after pricing the most actively traded bond was 5s of 2038 which broke 2 basis points better than originals.

Illinois

1/14: **Illinois** sold $480M general obligation bonds to **Bank of America Merrill Lynch**; Baa1/A-/BBB+; except bonds in 2034, 2037-2039 insured by AGM (A2/AA/NR); callable at par in 1/1/2026:

Pricing Notes: The state's first GO offering since April 2014 was bid aggressively relative to recent secondary trading levels.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	2.40	+123
2026	5.00	3.33	+144
2041	5.00	4.27	+151

Secondary Trading: AGMC insured 4s of 2039 broke 4 basis points firmer than originals on Friday; uninsured debt remained at originals.

California Health Facilities Financing Authority

1/12: **Morgan Stanley & Co. LLC** priced $475M Sutter Health revenue bonds for the **California Health Facilities Financing Authority**; Aa3/AA-/AA-; callable at par in 11/15/2025:

Pricing Notes: Strong demand resulted in large bumps, particularly 10-years and in; 5-year bond bumped 17 basis points.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.24	+7
2026	5.00	2.11	+21
2046	5.00	3.14	+31

Secondary Trading: The 30-year bond broke 3 basis points firmer on Wednesday and yields fell an additional two basis points by Friday

South Florida Water Management District

1/12: **Citigroup Global Markets Inc.** priced $395M certificates of participation for the **South Florida Water Management District**; Aa3/AA/AA-; callable at par in 4/1/2026:

Pricing Notes: Bonds were bumped 5 to 10 basis points 10-years and in; largest adjustments up front on the 5s of 2017.

Maturity	Coupon	Yield	+/- AAA 5%
2017	5.00	0.68	+29
2026	5.00	2.33	+43
2036	5.00	3.05	+45

Secondary Trading: 5s of 2035 broke 2 basis points better on Thursday before trading 6 basis points stronger than originals on Friday.