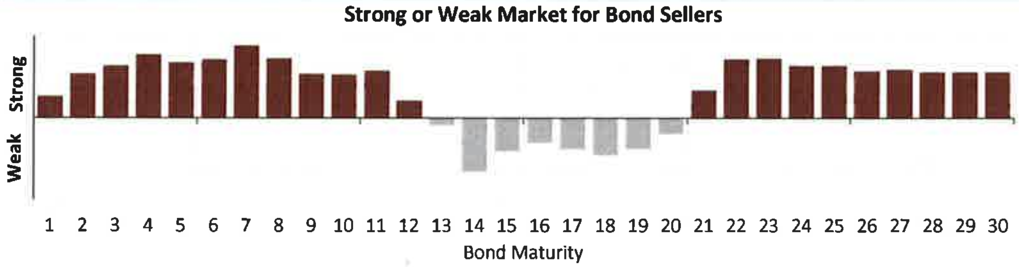
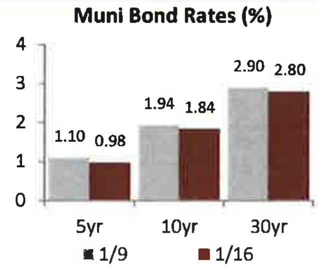
MMA Independent & Data Driven

JANUARY 20, 2015

MUNICIPAL ISSUER BRIEF





Heading into this week, strong performance of late has left a good dynamic across much of the maturity range for issuers. Still, issuers looking to sell bonds just outside of 10-years may find a more challenging dynamic as the aggregate dealer opinion is not as favorable there.

MARKET UPDATE

ANOTHER WEEK OF LARGE MUNICIPAL GAINS: The strong start to 2015 was extended last week with a massive flight-to-quality rally that pulled municipal borrowing rates to the lowest they have been in more than a year.

INVESTORS & ISSUERS: Strong performance puts issuers in good spot

- After a surprisingly strong start to the year, bond markets in the U.S.—including those for state and local governments—continued to post very large gains as the global economic situation appears to be deteriorating.
- With U.S. Treasury bonds rallying well through the 2% yield we noted last week in 10-years, municipal bonds followed suit and the decent sized slate of issuers did very well—especially the New York entities that saw very strong individual demand through their retail order periods.
- Early on in the week short maturities saw a very strong bid in secondary markets, led by a few large asset managers that were buying exclusively in that range, allowing issuers in the 5-year part of the curve to greatly benefit.
- Lower-rated healthcare, housing and land-based issues did better than higher-rated entities as the hunt for yield continues.
- This week the situation looks strong for issuers as we are at or surpassing 15-month yield lows.
- It is a larger-than-average supply slate for the holiday-shortened week and we will be specifically watching the interest in the $1 billion-plus Texas Transportation Commission issue plus dealer interest in the Washington GO competitive deal for how the general market fares this week.

MORE FOCUS ON PRIVATE CAPITAL: On Friday, the Obama Administration announced more efforts to entice private capital into infrastructure through its "Build America" initiatives. The administration created a new Qualified Public Infrastructure Bond (QPIB) that they said would be similar to private-activity bonds, though they will expand the scope, will have no expiration date and the interest on these bonds will not be subject to the alternative minimum tax. More information about these bonds will be included in the President's budget. That budget was the birthplace of the 28% cap on the amount of tax-exempt interest taxpayers can deduct in their federal returns, and we wouldn't be surprised to see some version of a cap in the next budget. The National Association of State Treasurers (NAST) sent a letter defending the exemption. (See **pages 2 & 3** for more.)

BUYERS BITES:

WHAT IS TRENDING HOT:

1) Higher-rated NY Issuers see strong demand
2) Lower-rated entities do even better
3) The 5– to 8-year range

CURRENTLY HARDER SELLS:

1) The intermediate portion of the curve
2) Puerto Rico underperforms

WHO IS REPORTEDLY BUYING:

Mutual funds, large domestic banks, European banks, SMAs

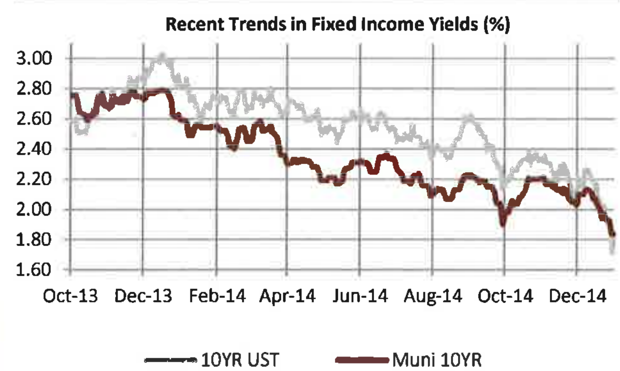


***Figure 1**: The last 15 months have generally seen borrowing costs lower for municipal issuers as seen in the chart above tracking the triple-A interest rate as the largest municipal dealers firms see it. As we note in Investors & Issuers to the left, Treasury bond rates have largely dragged exempt rates lower and lower with an emphasis on that move last week. This bodes well for issuers in the near-term.*

TOPICS OF THE WEEK

CONSENSUS SEES LOWER LONG BOND YIELDS: Recent events have increased the perspective among market participants that the curve flattening trend of 2014 will extend into 2015. Were this outlook to manifest, similar to 2014, issuers would experience opportunities to refund bonds. As a result, primary market activity would increase.

What this means for you: Advance refunding opportunities should be more abundant in 2015, giving issuers the ability to reduce annual debt service costs. Still, issuers should be conservative in assessing opportunities and not agree to refinancings too early, should conditions continue to improve. Also, look for investment bankers and municipal advisors to present more borrowing ideas that feature the kind of very long maturity borrowing (including zero coupon bonds) that investors are interested in buying. This kind of debt may not be appropriate for all issuers—and zeros are almost never a good idea—and, again, should be considered with some skepticism.

MOODY's PROPOSES NEW COUNTERPARTY RISK RATING: Many types of municipal bonds and other debt products rely on banks to structure their debt, for instance variable rate demand obligations, as well as provide letters of credit, and engage in derivative contracts. While not as prevalent as prior to the Recession, state and local governments still use these products, thus making the banks a counterparty to these types of transactions. Moody's has proposed a new "Counterparty Risk Rating" which will help the marketplace determine if a bank is likely to fail to meet their obligations in this capacity. Additionally, per the notice, "ratings of letter of credit and liquidity facility supported debts will be based on counterparty risk (CR) ratings."

What this means for you: Governments that engage in products where a bank is a counterparty in a transaction should be aware that some types of their debt may be rated in the future based on this new counterparty risk rating. Currently there is about $285 billion in bank-supported debt in the municipal sector. Governments that have outstanding bank-supported debt or plan to issue or use these types of products going forward may want to review the full report. This new type of rating will reasonably reduce issuers' tender and remarketing risk associated with bank-supported bonds and the associated negatives in cost and reputation. Assuming the proposed new rating is implemented, issuers of bank-supported short-term debt should enjoy some relief from additional rating methodology changes in the medium term.

LURKING PUERTO RICO ISSUES COULD AFFECT ENTIRE MARKET: In 2015, Puerto Rico's credit downside risk is elevated and rising given: 1) execution risk in substantial restructuring/reform efforts and; 2) the possibility of a budget shortfall in the neighborhood of $500 million.

What this means for you: Although many municipal investors have abandoned their Puerto Rico investments to hedge funds, the island still has an outsize impact on the day-to-day operations of the market. A painful or unexpected default by Puerto Rico could trigger selling pressure and force yields higher for all issuers. Further, Puerto Rico's travails have done some reputational damage to the municipal industry and municipal issuers generally. This includes our sector's reputation in Washington, D.C., implying that more problems with Puerto Rico raise the potential for more issuer-constraining Federal legislation and does little to help the argument on preserving the tax-exemption.

WASHINGTON, D.C. GEARS UP

FOCUS ON REFORMS BEGIN IN WASHINGTON: The Senate Finance Committee leadership announced last week it would form 5 working groups to analyze current tax law and discuss available reform options, including one group on "Community Development & Infrastructure." The new Chairman, Orrin Hatch (R-UT) and Ranking Member, Ron Wyden (D-OR), said the groups will work directly with the Joint Committee on Taxation (JCT) to develop a comprehensive report with recommendations for tax reform by the end of May. Today, Sen. Hatch spoke to the U.S. Chamber of Commerce and said he would pursue actual legislation this year, not just recommendations. Recall that Ranking Member Wyden has been a large proponent of tax-credit and direct-pay bonds and has in the past co-sponsored comprehensive tax reform bills with Republicans that would eliminate the tax-exemption for municipal bonds. While there is a question whether that idea initiated with former Sen. Judd Gregg or with Wyden, it is safe to say that Wyden's appreciation for the exemption is not so strong. Sens. Dean Heller (R-NV) and Michael Bennet (D-CO) will chair the "Community Development and Infrastructure" working group, which will include municipal bonds and all infrastructure items within the tax code. Both senators have introduced municipal industry-related bills; Bennet, a national infrastructure bank for roads, and Heller, one that would make the state and local sales tax deduction permanent.

Meanwhile, we also note a recent Congressional Research Service (CRS) report that submitted ideas on how the tax-exemption could be changed (eliminate private activity bonds, cap the deduction, among others) and the costs and savings of each aimed as a guide post for lawmakers. The JCT has written extensively of the exemption's costs to the federal government over the years, and has proposed ideas *(Continued on **page 3**).*

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

NORTHEAST

1/15: **JPMorgan Securities LLC** priced $850M transportation revenue bonds for the **New York Metropolitan Transportation Authority**; A2/AA-/A; callable in 5/15/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.51	+48
2025	5.00	2.27	+40
2045	5.00	3.04	+25

Notes: The issuer increased its deal by $350M due to strong interest

MID-ATLANTIC

1/14: **Virginia Beach sold** $23M storm water revenue bonds to **UBS Financial Services**; Aa2/NR/AAA; callable in 11/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2020	3.00	1.30	+27
2025	4,00	2.05	+18
2030	3.00	2.65	+39

Notes: Sub-5% cpns have been increasing employed competitively

MIDWEST

1/15: **Goldman, Sachs & Co.** priced $1490M Rush University Center Obligated Group revenue bonds for the **Illinois Finance Authority**; A1/A+/A+; callable in 5/15/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.59	+56
2025	5,00	2.50	+63
2030	5.00	2.94	+68

Notes: Health care deals have done very well of late

SOUTHEAST

1/14: **JPMorgan Securities LLC** price $99M senior lien local option gas tax revenue bonds for the **Jacksonville Transportation Authority, Florida**; NR/AA/AA-; callable at par in 8/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.35	+29
2025	5.00	2.15	+23
2035	5.00	2.84	+21

Notes: The issuer re-priced to much lower yields

SOUTHWEST

1/15: **First Southwest Company** priced $2.8M unlimited tax general obligation bonds for the **Clay Road MUD, Texas**; BAM insured; callable in 9/1/2022:

Maturity	Coupon	Yield	+/- AAA 5%
2021	4.00	1.85	+58
2025	3.50	2.43	+56
2026	3.50	2.60	+66

Notes: The short call and maturity structure made for good demand

FARWEST

1/14: **RBC Capital Markets** priced $104M University of Enterprise revenue bonds for the **Board or Regents of the University of Colorado**; Aa2/NR/AA+; callable in 6/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.30	+24
2025	4.00	2.10	+18
2035	4.00	3.01	+38

Notes: The market rallied the day this deal priced

WASHINGTON, D.C. UPDATE CONTINUED

(*Continued from **page 2***) such as eliminating advanced refundings and has generally been seen as not friendly to this sector. We also add that Rep. John Conyers' (D-MI) introduced a bill this year that would make it more difficult for cities to enter Chapter 9 bankruptcy protection, though this bill was aimed more at protecting public pensions and other benefits than making bondholders whole and it would not likely make it through the Republican-controlled Congress

All of this is to say that the headline risk **MMA** has warned would emerge coming into this new Congress may be beginning in earnest. **MMA** still believes that comprehensive tax reform before the 2016 presidential election faces an uphill battle, but the ideas that the Senate working groups produce will likely do damage to the municipal market in some form, whether tangibly through paying for one-off policy ideas or simply through the headlines they will create. And with Bennet as co-chair of the infrastructure working group and the latest out of the White House, expect the advocacy of private capital and public-private partnerships (P3s) to play a prominent role in 2015, a trend we noted last year. Possible too will be legislation aimed at either shoring up or curbing public pensions as headlines continue to roll out of Detroit, Illinois and New Jersey, among others.

Finally, recall that House Ways and Means Committee Chairman Paul Ryan (R-WI) has said that he would not pursue comprehensive reform because the Obama Administration would not work with Republicans, but he has thrown his support behind corporate tax reform, which many consider more plausible. However, there were hints out of the Obama administration at the end of last year that suggested they would be open to coming up with a set of "principles" with Republicans to guide reform efforts, which could further increase the odds of municipal industry challenges. It is set to be a busy 2015 in Washington.