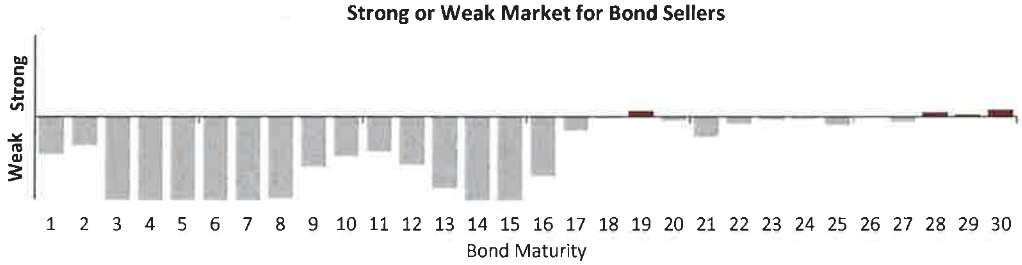
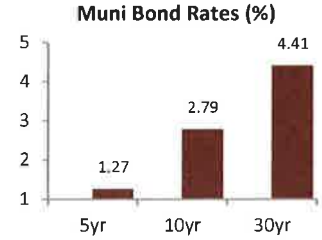
MMA The Power of Independence

JANUARY 6, 2014

MUNICIPAL ISSUER BRIEF





Heading into this week, the trend of the last three months has shifted. Some leading benchmarks cheapen their yield levels as the calendar year turns and this creates a weaker dynamic for bond sellers, most notably 15-years and in. With investor interest in short bonds (see below) we do not expect this trend to continue.

MARKET UPDATE

HOLIDAY LULL GRINDED MARKETS TO A HALT: There was very little activity over the last 2 weeks with both Christmas and the New Year coming on consecutive Wednesdays. Few issuers came to market and many secondary traders were on vacation.

INVESTORS & ISSUERS: This week normal market function resumes.

- **The last 2 weeks were a bust as far as market activity is concerned.** This week the market will begin to function normally with a modest jump in issuance scheduled.
- **One theme that did develop last week was that shorter-maturing bonds began to trade at richer levels**. Issuers should monitor this dynamic in the near-term as lower borrowing costs could be attained in shorter-maturities.
- **Last week the U.S. Treasury 10-year bond—a widely used benchmark for all bond markets—began to trade above 3% in yield.** This is the first time this has happened since June of 2011. The 3% threshold being breached is an indicator that many market participants expect interest rates to continue to move higher in 2014. Municipal bonds generally follow Treasury rates and thus all municipal bond issuers' borrowing costs are likely to rise. This week's **Topic of the Week** looks at market expectations for 2014. It can be found on **page 3**.
- **Triple-A rated Princeton University sells bonds competitively on Wednesday, January 8.** This issue will help to benchmark where the high-grade market really stands with investors as well how interested broker-dealers are in bidding competitively for issues in the first quarter of 2014. If you issue bonds competitively this is a deal to monitor.

MARIJUANA LEGALIZATION WATCH

- Last year the states of Colorado and Washington legalized marijuana for recreational use. **MMA** has been monitoring this issue as a potential new revenue stream for states and localities to securitize to meet growing infrastructure needs. Alaska, Maine and New York have recently advanced efforts to legalize the plant. This could be a very important—but divisive—revenue issue to monitor in 2014.

BUYER BITES:

WHAT IS TRENDING HOT:

1) State GOs rated AA or better
2) Bonds maturing in 10-years or shorter
3) Pre-refunded bonds

CURRENTLY HARDER SELLS:

1) Mutual funds
2) Bonds maturing 25-years and out

WHO IS REPORTEDLY BUYING:

Separately managed accounts, large banks, direct retail active in start of year for shorter maturities

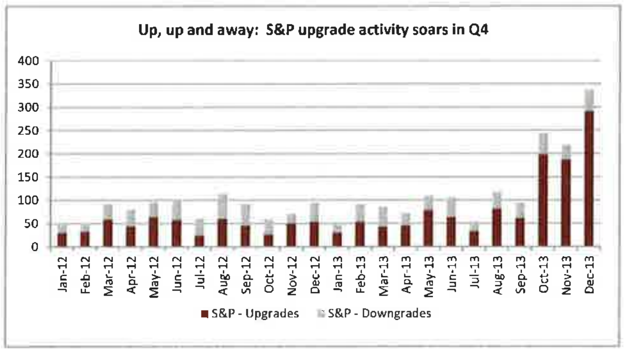


Figure 1: *The rating agency Standard & Poor's has been increasingly upgrading municipal issuers in 2013 according to data compiled by The Bond Buyer. Last month the **MIB** reviewed what these upgrades mean for issuers as well as what the divergence from Moody's Investors Service means for issuers. Those reports can be found here and here.*

TOPIC OF THE WEEK: MARKET OUTLOOK

MARKET OUTLOOK FOR 2014: This week **MMA** offers an outlook on the market. A few positive projections for issuers:

- **Overall 2014 Issuance to fall**. **MMA** projects this year's total municipal bond supply to be in the $275 billion to $300 billion range led by an uptick in new-money issuance. The 2013 final issuance figure was $329 billion—see **Figure 2** below*). The projection of slightly less issuance in 2014 tips the supply/demand balance in favor of issuers.*
- **Shorter Maturities to Do Well**. While the taxable bond markets are seeing shorter-maturing bonds lose value, we see continued investor interest in shorter-maturing municipal bonds until the Federal Reserve increases its funds target rate.
- **Improved General Municipal Credit Trend**. As far as broad credit trends, **MMA** anticipates recently improving trends to continue, particularly over the next 3 months as fiscal year 2013 comprehensive annual financial reports are disclosed.
- **Advance Refunding Opportunities May Resume**. If shorter maturity Treasury rates move materially higher it could create opportunity to do advance refundings, which have been mostly impossible for the last 2 years because of the relative strength of US Treasury rates versus tax-exempt rates (negative arbitrage). *Issuers should consider the option of an advance refunding in this growing higher, but still historically low, interest rate environment.*

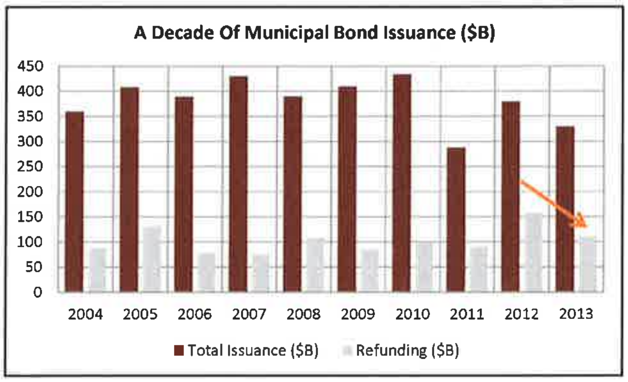


Figure 2: *Total issuance declined in 2013 after the 2012 surge in refundings faded. **MMA** expects refundings to continue to diminish in 2014.*

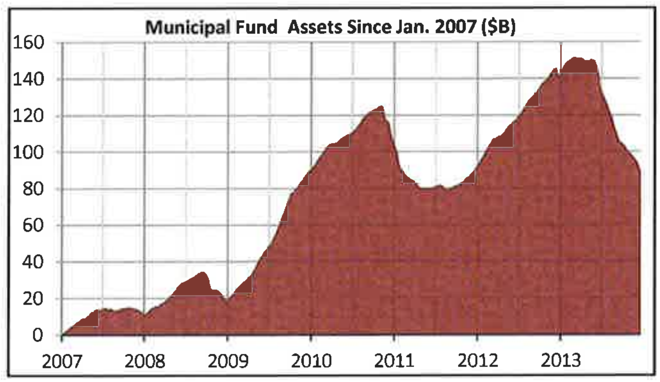


Figure 3: *At their peak, municipal bond mutual funds owned nearly $150 billion municipal bonds. Since April, investors have pulled over $60 billion.*

Areas that will require more issuer diligence:

- **Higher Yields**. Yields will rise as bond investors move their investments more into the stock market, however, the magnitude of the interest rate rise depends on investor demand for bonds as well as the continued recovery of the US economy and pace of inflation. *An expected increase in yields means issuer borrowing costs generally will go up.*
- **Long-Term Buyers Still Elusive**. With a smaller consistent investor base of longer-maturing bonds, outside of a few large bank buyers and non-traditional investors, we expect longer-dated bonds to weaken further than other maturities. New regulations being put in place in 2014 may make it more difficult for large banks to participate in the market—*keep an eye out for this.*
- **Headline Headaches Continue**. Headlines will be largely negative with the media's specific focus over Puerto Rico's woes and Detroit's bankruptcy proceedings. This could spur volatility for the overall market, particularly as Puerto Rico's bonds may be downgraded to junk in the next 6 months. *Although the headlines may have nothing to do with your locality, their effect on the entire market could be a problem for your issuance. In some cases the investor in Puerto Rico has also invested in your issuance and a negative headline could mean they sell all their municipal holdings, which could increase the cost of your next borrowing.*
- **Refundings May Struggle**. Refundings will continue to be on a downswing (see **Figure 2 above**). Higher yields will make current refundings less available to issuers. *This will lower your ability to save on a refunding.*
- **Mutual Funds Will Continue to Lose Investors in 1Q14.** Mutual funds that invest in municipal bonds have lost $62 billion in cash since April of last year in the longest consecutive streak of weekly losses ever recorded (see **Figure 3 above**). **MMA** estimates the funds have roughly another $10 billion of cash to lose before the bleeding stops—implying losses will continue into at least February. *Fund selling has disrupted normal secondary market functions in the last 9 months. When funds sell their municipal bonds in secondary markets they are in essence competing with issuers for investor attention when they sell in the primary markets. When the mutual funds stop selling, this will be a major positive for the market.*
- **Greater Bond Insurance Use Minimal in 2014**. More issuers may use bond insurance in the year ahead but with only about 3% of new issues having insurance over the last 2-years, the industry has had little impact on most governments.