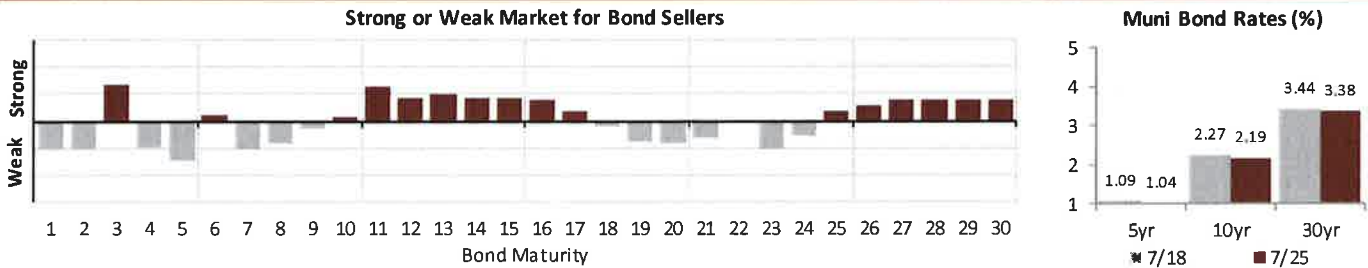
MUNICIPAL ISSUER BRIEF



Heading into this week, issuers see the most strength of bonds in the middle of the curve, beginning in 10-years as last week's move to lower yields mostly occurred in that range. There is also strength out longer, as a dearth of new issuance is keeping municipal rates low in general.

MARKET UPDATE

THE RALLY CONTINUES: As of Friday last week, interest rates paid by municipalities were at their lowest in 12-months as many bond markets improved. Municipals have performed better than most fixed-income sectors buoyed by the lack of issuance.

INVESTORS & ISSUERS: The lack of supply continues to drive market

- Most issuers have seen very strong investor interest and **we expect the same this week** as supply is below historic averages.
- Last week other fixed-income sectors started strong on continued concerns over global warfare and tension; **tax-exempt interest rates continued to move lower in secondary activity, even after U.S. Treasury bonds faded as the week ended.**
- Helping rates continue to move lower was the state of **Maryland**'s triple-A competitive deals that sold on Wednesday. Not only did dealers purchase the GOs at very aggressive levels, they did so after the state increased the size of its loan to $1 billion+.
- It wasn't just the larger or high-grade issuers that benefited though, as last week saw a lot of the lower-rated issuers such as **Oyster Bay, NY** (BBB) and **Guam Waterworks Authority** (A-) saw strong mutual fund interest, **plus smaller bank-qualified deals were also seeing large oversubscriptions.** (See **page 3** for more on regional deals.)
- While new-issues are seeing vibrant interest, the types of municipal buyers **is becoming influenced by investors** (large banks or property & casualty insurance companies) **who don't frequently trade their holdings in secondary markets**. This not only hinders secondary price discovery, which can make pricing new-deals more difficult (see ***Figure 1)*** but also hurts dealer firms' revenues as there are less bonds to trade. Chose your underwriter wisely
- This week, the market context heavily favors issuers and the **University of California**, **Suffolk County** and **San Antonio** will discern the tone for the general market.

MSRB RELEASES MA RULE: The Municipal Securities Rulemaking Board (MSRB) released 2 rules regarding municipal advisors. Rule G-44 is the first rule for which the MSRB is seeking SEC approval, aimed at supervising municipal advisors and ensuring compliance with all applicable securities laws. The MSRB also said it has additional rules and professional qualification standards for municipal advisors in various stages of development. The MSRB currently is seeking public comment on a revised draft rule to establish core standards of conduct — including interaction with issuers — for municipal advisors.

BUYERS BITES:

WHAT IS TRENDING HOT:

1) Maryland GO
2) Higher-rated healthcare
3) Non-Puerto Rico territories
4) Bank-qualified

CURRENTLY HARDER SELLS:

1) Illinois
2) Washington GO

WHO IS REPORTEDLY BUYING:

Large banks, property & casualty insurance companies, mutual funds

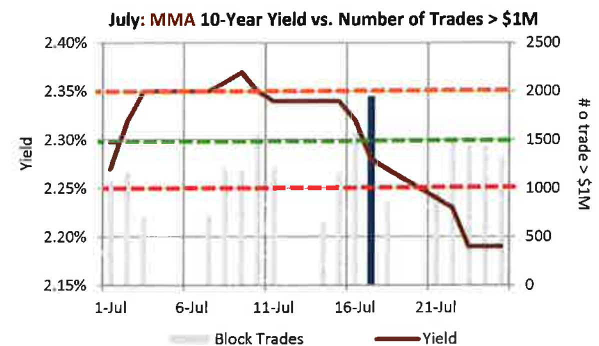


***Figure 1**: Less issuance over the last 12 months and more 'buy-and-hold' investors purchasing bonds via the primary markets is making for less trading overall in secondary markets for municipal bonds. The chart **above** tracks the 10-year yield (maroon line) with the corresponding number of trades that were of $1 million or more (block trades) that occurred each day. A busy day of trading has 2,000 of these trades or more (the yellow doted line) of which there have been none this month. On July 17th (blue bar) the market came close with 1,917 that day as the market responded to the downing of the Malaysian airliner over the Ukraine*

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WHAT ISSUERS CAN LEARN FROM TAYLOR SWIFT

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Musicians at one time wrote a song, were discovered by a label, who then handled all the distribution logistics associated with making a record a hit. For more than 100 years, when a government entity needed to raise capital, a banker would adopt the risks and ensure funds were raised. The future of the music industry was forever altered by the internet, and now, similarly, the municipal bond industry is on the cusp of a shift in how states and municipalities conduct their own financial business.

In July 7's *Wall Street Journal*, the musician Taylor Swift contributed an op-ed on the music industry in the era of social media. Municipal issuers could take note of the themes Ms. Swift articulated about the changes in the music industry that necessitated a new process to distribute her songs. In the comparison to the music industry, municipal issuers are the artists. Like an artist who has a need to attract fans, so too does the issuer need to attract investors. Ms. Swift's perspective emphasizes the need of performers to use social media to attract fans who will buy their product. Similarly, municipal issuers (especially in the wake of Detroit, Illinois, a handful of California cities and Puerto Rico) need to use new means to attract their fans, i.e. investors. While issuers do not necessarily need to maintain a Facebook page or an active Twitter account; it is imperative for state and local governments to become better with timely disclosure, updating and maintaining their websites and holding events for investors to discuss the topics and challenges. State and local governments can learn from Massachusetts, which has provided examples of thoughtful and active communication in recent years. The Commonwealth has held an annual investor day to inform potential and current investors of its fiscal health, its website has been designed to engage investors, it has created a process to sell its bonds directly to individuals, and finally, it has been diligent in filing its timely financial disclosure.

The municipal bond industry has experienced a gradual shift over the past decade. The traditional process of issuers raising capital and distributing the risk to investors has changed. Municipal issuers are even more dependent on the core demand from individuals for their bonds and that is likely to remain the case. What has changed is the margins and returns that banks and security firms derive from taking on the risk to provide the capital while also placing your bonds with the end investor – the ultimate lender.

The distribution of bonds, the effective process of crowdsourcing capital for infrastructure and operational needs has become even more challenged by the rapidly evolving regulatory environment led by the Securities and Exchange Commission's new advisor rule and disclosure regulations, as well as new Municipal Securities Rulemaking Board rulemakings. The additional costs and risks of the new regulations may prompt banks to review the efficacy of providing capital to issuers. This new era of regulation is unfolding as revenue from traditional primary and secondary transactions has diminished. In the early 2000s municipal bond dealers generated a large percentage of their revenue from derivatives, not traditional bond transactions. Broadly across the industry, traditional bond financing and its associated revenue was discounted to garner the derivative (and more lucrative) transactions. The business decisions were not unlike a local 7-11, which uses loss leaders of bread and milk to make more revenue from its branded Slurpee. With the near elimination of the municipal derivative market, reduced margins for traditional transactions, less primary issuance volume, reduced secondary trading, greater regulatory costs and the risk of rising interest rates, the municipal industry's business model is under considerable stress.

Over the next year, it is conceivable that municipal dealer bank departments will contract and that capital available to municipal issuers will become dearer. The revenue from effectively lending money to issuers and distributing bonds to investors may not justify the costs and risks. Understand that the municipal bond industry has represented an efficient way to crowdsource the capital to build a bridge or a water treatment plant. Municipals were in effect the original Kickstarter. So now change will have to occur – old ways of doing business will become extinct and new participants and practices will emerge. The good news is that the basic need for capital and provision of capital will remain, it simply will be different.

What will that change look like? Mark Mulligan's June 4 article via *Business Insider* points out how the traditional distribution of artists' songs to consumers has been altered. He notes that between 2000 and 2013, the global music industry's revenues have held their own, though recorded music revenue has fallen 41%. Offsetting the decline from recording is a 60% growth in live performance revenue. Labels are deriving less revenue from artists yet "the same artists still need the recording to drive the live and merchandise income." So the municipal issuer, as the artist, still needs the banker but how the banker derives revenue from its involvement with issuers will be measured in a much more holistic context. The music industry is now dominated by "360" deals that encompass all revenue opportunities of an artist not simply the recording. Perhaps the municipal issuer and its traditional banker relationship will (and is already in the process) transform from being less defined and driven by the bond deal and more by the variety of services a financial institution provides to an issuer. In fact, the emergence and growth of the municipal direct loan market may have already contributed to municipal public finance operations reviewing their interaction with issuers in a 360 way. As the second half of 2014 is under way, it is critical that municipal issuers be prepared to adapt to the dots and broken models. But, I, like Taylor Swift, am an eternal optimist and believe that solutions and leaders will emerge to address the needs of the nation.

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

NORTHEAST

On July 24th, **Oyster Bay, New York** sold $170 million of limited tax general bonds to **Citigroup Global Markets Inc.**; NR/BBB/NR; callable in 8/1/2022:

Maturity	Coupon	Yield	+/- AAA 5%
2019	3.25	2.00	+95
2024	3.25	3.12	+93
2029	4.00	3.76	+98

Notes: Smaller coupons, Assured insured made for a lower TIC

MID-ATLANTIC

On July 23rd, **Maryland** sold $1.1 billion of general obligation bonds to **Morgan Stanley & Co. & JPMorgan Securities LLC**; Aaa/AAA/AAA; the first sale, $656 million, were not callable:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.25	1.43	+1
2022	5.00	1.89	-2
2024	5.00	2.17	-6

Notes: These set the tone for high-grades, benefitting all issuers

MIDWEST

On July 24th, **Citigroup Global Markets Inc.** priced $108 million of water system revenue refunding bonds for the **Central Brown County Water Authority, Wisconsin**; NR/A+/AA-; callable in 11/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.54	+49
2024	5.00	2.76	+57
2034	5.00	3.58	+42

Notes: A +42 basis point spread in 20-years is an excellent rate

SOUTHEAST

On July 24th, **Raymond James & Associates** priced $164 million of hurricane recovery program revenue bonds for the **Louisiana Public Facilities Authority**; Aa3/NR/AA-; callable at par in 6/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.39	+34
2024	5.00	2.59	+40
2027	5.00	2.92	+34

Notes: This deal was re-priced to lower yields on shorter bonds

SOUTHWEST

On July 22nd, **Mesirow Financial Inc.** priced $257 million of public improvement refunding bonds for **Houston, Texas**; Aa2/AA+/NR; callable in 3/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.30	+21
2024	5.00	2.43	+19
2034	4.00	3.51	+33

Notes: The 10-year saw strong demand and bumped 5 bps

FARWEST

On July 22nd, **Piper Jaffray & Co.** priced $365 million of current interest bonds for the **Beaverton School District 48J, Oregon**; Aa2/A+/NR; callable in 6/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.57	+17
2024	5.00	2.40	+16
2034	5.00	3.16	+2

Notes: Retail demand was very high for the school district

REGULATORY ROUND UP

SEC MMMF REFORMS: Last week, the Securities and Exchange Commission (SEC) voted on changes to SEC Rule 2a-7, which regulates money market mutual funds (MMMFs). The long-awaited vote did not fall in favor of state and local governments. **Of greatest importance, the funds must now convert from using a stable net asset valuation (NAV) method to a floating NAV method.** State and local governments that use MMMFs for their short-term cash-management and investment strategies will be largely affected, since these products are (were) preferred because of the easy-to-manage and stable NAV. Many governments have statutes mandating the use of stable NAV investments, and will now have to adjust their procedures and investments accordingly. While the rule exempts funds from using a floating NAV, if they sell to retail customers, the definition of retail is set as "natural persons" which does not include state and local governments. Further, MMMFs are the largest purchaser of short-term municipal securities. **The rulemaking may decrease funds' appetite for these products, because of the increased compliance and tax obstacles. Issuance costs may rise for state and local governments, as demand is dampened for short-term debt.**

The rule change will be effective 2 years from its publication in the Federal Register, which should be forthcoming in the next week, meaning **implementation will occur July-August 2016.**