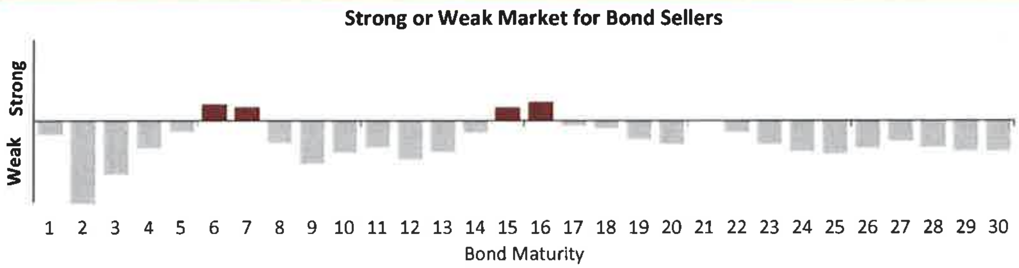
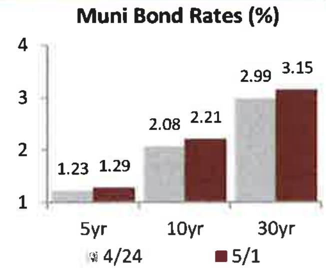
**MMA** Independent & Data Driven

MAY 4, 2015

# MUNICIPAL ISSUER BRIEF




*Heading into this week, the pricing context for municipal issuers remains challenging. Weakness (gray columns) has persisted throughout the yield curve. Underwriters are apt to price issues cautiously not only in a context where their capital is limited but also ahead of a major economic report—unemployment on May 8.*

## MARKET UPDATE

**BORROWING COSTS RISE UNDER PRESSURE FROM OTHER BOND MARKETS:** The market for municipal bond suffered nearly every single day last week as interest rates worldwide rose and investors could afford to be selective and patient with purchases.

**INVESTORS & ISSUERS**: This was yet another difficult week:

- Under pressure from rising interest rates worldwide, **the borrowing costs for issuers last week increased across the curve**.
- Looking specifically at the municipal market, several of the similar themes continued to create problems in the current market dynamic: persistent difficulty to move bonds off balance sheets from the same dealers underwriting new issues, selling pressure by asset managers continued in secondary markets and **the Treasury market rose 20 basis points from Monday to Friday**, making price discovery for municipal pricings difficult.
- Still, there were two important positive elements that could play a role for the balance of the month: mutual funds stabilized and weekly investment flows turned positive, while **retail brokerage networks noted more individual demand for municipal bonds.**
- This was especially evident in the Commonwealth of Massachusetts' bond deal wherein underwriters saw strong **pre-sale interest from above-mentioned parties** (see page 3 for details).
- Looking ahead to this week, **supply will increase** to levels more consistent with the large volume seen for much of 2015.
- Different from previous big weeks, the calendar is not led by a $1 billion-plus refunding; but rather a smattering of medium-sized issues that in many cases aren't the run-of-the-mill type.
- For example, there are several stadium, bridge and healthcare deals that are not frequent in the marketplace—these issuers tend to attract non-traditional investors and thus are not expected to have an effect on more traditional issuers who will also price. The broader market negatives will be the bigger factor.

**LSU:** Two weeks ago Louisiana State University was forced to cancel its bond sale after the media picked up on offering document language that highlighted the university's reliance on state budgets that were likely to see cuts. The deal had priced and was near closing when this all occurred—a rare occurrence in the market, which highlights the increasingly important connection between local issuers and state budgets. Read more about the sale here.

### BUYERS BITES:

**WHAT IS TRENDING HOT:**

**1) Shorter maturities continue to benefit from corporate buyers**

**CURRENTLY HARDER SELLS:**

**1) Lower-rated healthcare underperforming**
**2) Chicago school and GO**
**3) Puerto Rico GO**

**WHO IS REPORTEDLY BUYING:**

**Mutual funds, large domestic banks, SMAs, Tech-oriented corporations**

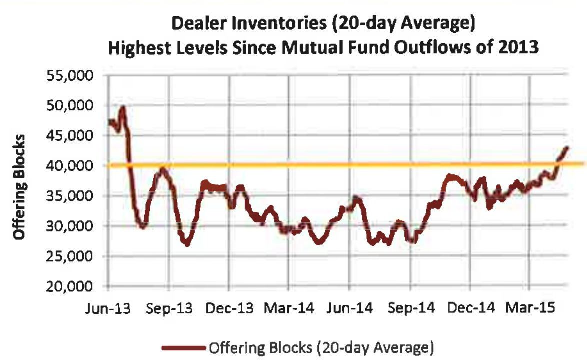



***Figure 1**: Municipal issuers this week are pricing in an adverse market context. Technically, both municipal and Treasury momentum indices of price direction have turned negative. Also, evaluations of municipal bonds have risen significantly so that the premium pricing of which issuers have benefitted in recent months has disappeared. Finally, dealer inventories, as measured by offering block totals, are as high as they were in summer 2013 (see yellow line in illustration above). Summer 2013 was when mutual fund outflows contributed to a 100 bps rise in MMA's 10-year benchmark yield. Dealers are apt to price new issues at levels to move quickly to reduce capital exposure.*

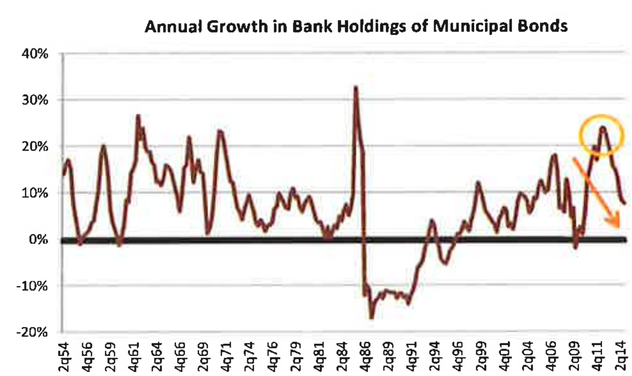
## TOPIC OF THE WEEK: ARE MUNICIPALS 'LIQUID'?

**HIGH-QUALITY LIQUID ASSETS:** The ongoing debate as to whether U.S. bank regulators will determine that municipal bonds are high-quality liquid assets (HQLA) has entered another chapter. Last month, it was reported by the *Wall Street Journal* that the Federal Reserve would designate certain issuers in the municipal market to be considered the sought-after HQLA categorization. This occurred after the Fed initially did not include the municipal market as HQLA. While the *Journal* article was based largely on anonymous sources, we discussed this issue in October of last year (see report here) and understand that there is a large push to change the municipal designation. In fact, just today a bill was proposed that would force certain municipal bonds to be treated as HQLA. To review the topic at hand: the Federal Reserve and other federal regulators are tasked with implementing worldwide banking rules (called Basel III) for U.S. banks. Part of those rules involved deciding which investments that a bank has and the amount of collateral it must have to cover its liabilities to ease liquidity/resolution concerns. As an asset class, being considered HQLA makes it more attractive for a bank to invest and own that type of investment. Initially, municipals were not considered HQLA—or basically a liquid, or tradable investment. As a result, a bank would have to post more collateral to own a municipal bond.

**WHAT THIS MEANS FOR YOU:** Since banks are the third largest holder of municipal bonds, the public finance industry is concerned that this designation creates a hurdle for banks to continue to be an active participant in the municipal bond market. This has become particularly important as banks have played a major role in the market's recovery from the financial crisis and continue to be a major buyer of municipals. Bank demand has helped to keep interest rates lower (one bank alone purchased $1 billion bonds in the 1st quarter of 2015). Still, bank purchases on a net basis have slowed (**see illustration below**). As a result strong lobbying efforts have increased the likelihood that, at least, the Federal Reserve would designate municipals as HQLA. While a positive, **MMA** does not think bank regulators will designate the entire universe of municipal bonds as HQLA. Instead, we expect the designation to be defined by the amount of bonds an issuer has outstanding, which in effect would penalize smaller issuers. This is not a positive development as smaller issuers benefit greatly from bank demand thus are at risk of having less access to low-cost capital.

The industry has equated the non-HQLA designation to higher borrowing costs for affected municipal issuers. **MMA** does not expect borrowing costs to rise widely as a direct as a result of this ruling. However, in a period of financial stress this designation could become a greater concern. In a situation where a bank has to sell its assets, non-HQLA investments would likely be the first to be sold and could exacerbate a negative trend in, likely, already turbulent waters.

Perhaps more important than near- or long-term borrowing costs is the ultimate stigma of being labeled "not high-quality" and "not liquid" by the Central Bank and other important regulatory bodies in the U.S. This would create a negative perception about not only labeled issuers but also the broader marketplace since investors are especially sensitive to media coverage.




## REGULATORY ROUND-UP

**MSRB ANNOUNCES MA EXAM:** The Municipal Securities Rulemaking Board (MSRB) announced that it has developed the content outline for the new Municipal Advisor (MA) exam. MAs may participate in the MSRB's pilot program through the end of 2015, with the test becoming mandatory for these professionals in 2016. The *Dodd Frank Act* mandated that municipal advisors be regulated and meet professional qualification and conduct standards, which the MSRB is in the process of implementing.

The MSRB also held its spring board meeting and announced various initiatives that it plans to address in 2015. In addition to new MA rulemaking, the Board will be looking at adding pre-trade information on EMMA, developing a rule to require dealers to provide pricing reference information, and finalizing the best execution standards. The best execution rulemaking would force municipal dealers to sell bonds to investors as "favorably as possible under prevailing market conditions."

**GASB LOOKS AT MUNICIPAL DISCLOSURE:** At its meeting late last month, the Governmental Accounting Standards Board (GASB) authorized staff to research potential improvements to debt disclosure guidance. The reasoning behind this research is to address the different types of debt that state and local governments are using, including direct bank loans. The research "will focus on whether notes to the financial statements currently provide sufficient debt information to financial statement users for decision making and assessments of accountability."

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

**Three large deals that moved the market last week and why (highlighted in yellow):**

- High-grade and frequent issuer **Massachusetts** sold two competitive GO deals in the midst of challenging market conditions on Thursday last week. Both series were aggressively bid by underwriters—with the larger portion going to BAML with a 5-basis point cover bid (there were total 8 bidders). The Commonwealth's premier disclosure and retail friendly website played a part in still achieving strong results despite general market headwinds.
- **Whelan Energy of Nebraska** served as an early sign of negative market conditions when this lower-rated but still investment grade issuer had to raise yields as much as 8 basis points to close the account on Tuesday—it was an indication of the deteriorating pricing environment for issuers.
- **Grossmont Health** found strong insurance company interest in lower coupons outside of 10-years—other issuers may as well.

## NORTHEAST

4/30: **Massachusetts** sold $450 million general obligation bonds to **Bank of America Merrill Lynch**; Aa1/AA+/AA+; callable at par in 5/1/2023:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2035 | 4.00 | 3.53 | +67 |
| 2040 | 4.00 | 3.70 | +69 |
| 2045 | 4.00 | 3.75 | +67 |

**Notes: True interest cost for this series was 3.901%**

## MID-ATLANTIC

4/29: **RBC Capital Markets** priced $6.1 million general obligation bonds for the **Crestwood School District, PA**; NR/AA-/NR; callable at par in 9/1/2020:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2016 | 0.60 | 0.60 | +38 |
| 2020 | 2.00 | 1.65 | +41 |
| 2025 | 2.35 | 2.43 | +33 |

**Notes: Bank Qualified helped secure nearly 2% coupon payments**

## MIDWEST

4/28: **Bank of America Merrill Lynch** priced $206 million Whelan Energy Center Unit 2 revenue refunding bonds for the **Public Power Generation Agency, NE**; A2/BBB+/A-; callable at par in 1/1/2025:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2020 | 5.00 | 1.83 | +60 |
| 2025 | 5.00 | 2.78 | +70 |
| 2031 | 5.00 | 3.46 | +92 |

**Notes: Even at +80-ish in 16-years the issuer had to cut prices**

## SOUTHEAST

4/27: **Stifel Nicolaus & Co.** priced $14.9 million revenue bonds for the **Upper Oconee Water Authority, GA**; Aa2/NR/NR; callable at par in 7/1/2025:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2022 | 5.00 | 1.93 | +27 |
| 2025 | 5.00 | 2.38 | +30 |
| 2027 | 5.00 | 2.68 | +39 |

**Notes: Yields were in line with the single rating**

## SOUTHWEST

4/29: The **Sanpete School District BOE, UT** sold $15.2 million general obligation bonds to **Morgan Stanley & Co.**; A1/NR/NR; Sch Bond Gty (Aaa/NR/NR); callable at par in 3/1/2025:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2020 | 5.00 | 1.43 | +19 |
| 2025 | 5.00 | 2.21 | +11 |
| 2028 | 4.00 | 2.80 | +40 |

**Notes: The extra state guarantee likely saved at least 20 basis points**

## FARWEST

4/28 **Goldman, Sachs & Co.** priced $227 million general obligation and refunding bonds for the **Grossmont Healthcare District, CA**; Aa2/NR/NR; callable at par in 7/15/2025:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2020 | 5.00 | 1.49 | +26 |
| 2025 | 5.00 | 2.36 | +28 |
| 2040 | 4.00 | 3.75 | +82 |

**Notes: The 4% coupon in 25-years was result of P&C companies.**