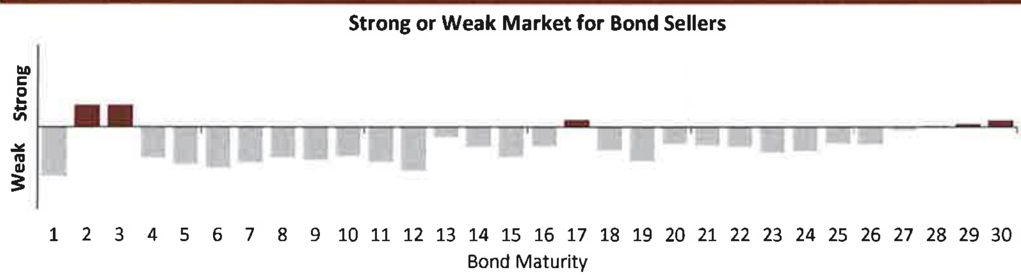
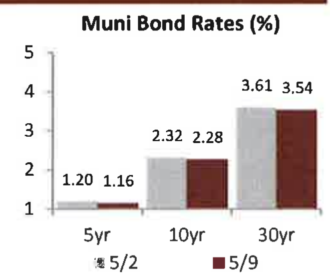
MMA The Power of Independence

MAY 12, 2014

MUNICIPAL ISSUER BRIEF





Heading into this week, a weaker pricing dynamic was maintained as investors have displayed reluctance to chase the low absolute yields. Nonetheless, there remains considerable funds pursuing the relatively light tax-exempt issuance.

MARKET UPDATE

MUNICIPAL BORROWING RATES COINTINUE TO MOVE LOWER: The tax-exempt market proved resilient by continuing to move to lower interest rates, despite losses in taxable bond markets. Municipals tend to follow taxable price action.

INVESTORS & ISSUERS: Municipals continued to grind to lower yields.

- Lack of supply this week once again **helps issuers that are pricing bonds**. Even with low rates and weakness in other markets last week, municipals did not unhinge from the recent rally.
- **Mutual funds that buy municipal bonds reported that they received the largest amount of new investments in 15 months**. This is a big boost for the marketplace and late last week it put municipals in a decidedly positive tone.
- The new investments, along with a few larger pension and insurance funds, put the market in go-mode last Thursday and Friday as trading picked up and issuers saw very strong demand.
- **Higher-yielding credits continue to perform the best in this market.** The above-mentioned interest in mutual funds has largely benefited funds that specialize in higher-yielding credits and these funds continue to dominate demand. Lower-rated issuers should take note.
- **Demand for California, New York and New Jersey issues returned last week after a short hiatus.** It was not just high yield that improved, but also many of the better-rated issuers from these three states helped establish the positive tone. Many mutual fund complexes have specific funds for these states.
- **Sub-5% coupons are on the rise in 2014 as insurance companies have become more active buyers of late.** This can be beneficial for bonds issued in the 15- to 25-year range, and this buyer type's participation might produce better levels for issuers.

IRS GLITCH ON BABS: The Internal Revenue Service has asked some issuers to pay back part of the federal subsidy payments for direct-pay BABs because the wrong sequestration reduction rate was used. The IRS' tax-exempt bond office said that due to a processing glitch, some issuers that should have had their subsidy payments reduced by 8.7% instead had their payments reduced by only 7.2% and a few hundred issuers were affected. The IRS recently sent letters to the issuers asking them to pay back the difference between what they were paid and what they should have been paid. Proponents of the direct-pay model should know that the IRS has never asked an issuer to pay any additional amount on a tax-exempt bond due to 'glitches'.

BUYERS BITES:

WHAT IS TRENDING HOT:

1) California, New York & New Jersey
2) Longer maturities
3) Short-call options
4) Higher education, correctional facilities & healthcare

CURRENTLY HARDER SELLS:

1) Puerto Rico

WHO IS REPORTEDLY BUYING:

Life insurance companies, high-yield mutual funds

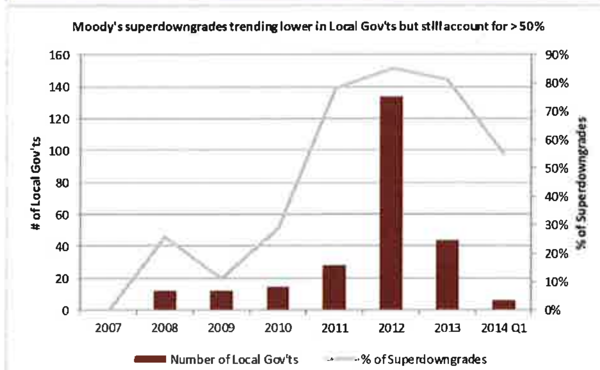
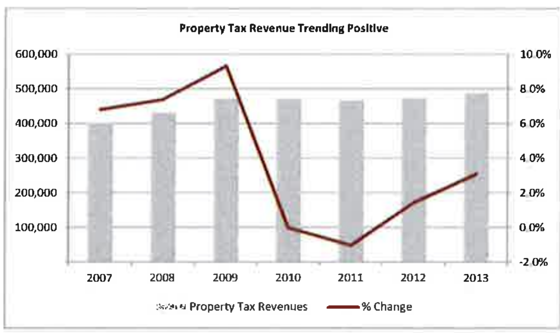


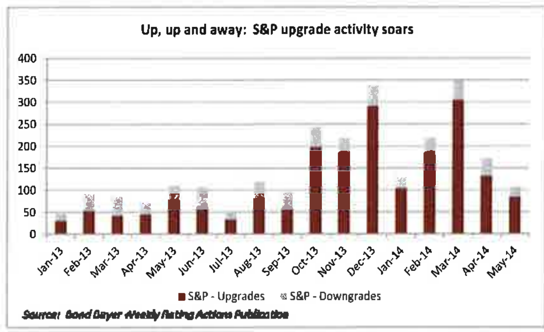
***Figure 1:** Superdowngrades, or downgrades of 3 notches or more, continued to decline so far this year. The peak in 2012 was a result of the demise of California Redevelopment Agencies. This implies that the rating agencies have either turned less bearish on municipal credit or have incorporated the bulk of recession-era financial postings into their ratings. This is an incremental positive for the market but the legacy of these actions encourages continued caution. Recently several metrics have been released that are steady to positive for the state of municipal credit. Learn more in this week's **Topic of the Week** on **Page 3**.*

TOPIC OF THE WEEK: TAX REVENUE, EMPLOYMENT & RATINGS TRENDS

SIGNS POINT TO IMPROVEMENTS: Property tax revenues rose in 2013 for the second year coming off the Great Recession-induced low in 2011. An improving housing market has benefited this critical local government revenue component, which accounts for 75% of local government tax revenues and 30% of general revenues. Additionally, in April, state and local employment rose by another 81,000 versus April 2013: the largest year-over-year gain since February 2009. Meanwhile, it is expected that local government rating trends will follow their current patterns for the balance of 2014. According to *The Bond Buyer* "Weekly Rating Changes," **Moody's Investors Service's** negative rating momentum appears to be slowing whereas **Standard & Poor's** continues to rapidly upgrade ratings (**figure below, right**) in conjunction with the implementation of its new methodology (see this December issue of **MIB** for more on ratings). **MMA** expects S&P upgrades to continue to outpace downgrades at an elevated level.

WHAT IT MEANS FOR YOU: These are generally constructive developments and frame the broader state of municipal credit positively for potential investors. There are caveats though. While property tax growth is undoubtedly positive for local government finances, when adjusted for inflation, this revenue source still remains about 5% below its 2009 peak (**figure below, left**). Also, growth of other local government expenditures, such as pension contributions and retiree benefits, has been rising at a more rapid rate. At least in the near- to medium-term, property tax revenue growth is thus more likely to be a credit quality *stabilizer* for the sector versus an *enhancer*. The takeaway of the increase in state and local employment is modestly positive for an increase in new-issue supply, as issuers begin to reinstate prior service cutbacks and look forward to investment in services and infrastructure. April's state and local job gains were driven by local, non-education areas that are predominantly transportation and general administration areas, both of which have historically coincided with growing infrastructure demands.





In its report on credit conditions for State and Local Governments, S&P appropriately noted that its view of the sector is *generally* improving. Most issuers in these sectors will benefit from a continuation of the last 5 years of measured economic expansion. But, since the Great Depression, the median time between recessions has been about 4 years and a maximum of 10 years. Investors will take note of any renewed economic weakening, which could compromise revenue growth. Additionally, the increasing prevalence of property tax caps—fueled by anti-tax sentiment—will likely reduce the fiscal flexibility of local governments and hinder the ability of those affected to address revenue pressures. Focus on municipal credit has been heightened in the wake of the financial crisis, so all issuers should be aware that macro trends might now exert a greater force on borrowing costs than in the past.

HIGHWAY FUNDING & REGULATIONS

HIGHWAY FUNDING: Senator Barbara Boxer (D-CA), chairman of the Senate Environment and Public Works Committee, announced she would introduce a 6-year extension of the current two-year law transportation funding law at current funding plus inflation. Boxer was joined by the Republican leader of the committee, Ranking Member David Vitter (R-LA) in announcing a markup of the reauthorization of the Moving Ahead for Progress in the 21st Century, or MAP 21. Recent discussions of the gap in US infrastructure have intensified, culminating in a new report on widespread bridge deficiency by the American Road and Transportation Builders Association and the Federal Department of Transportation projecting the Highway Trust Fund will run out of cash by August 29. This comes after a Senate Finance Committee hearing earlier in the week focused on ways to finance transportation. Of note, Finance Committee Chair Ron Wyden (D-OR) again touted the resurrection of a BABs-like product to help close the funding gap. There still is much uncertainty over whether a multi-year transportation bill could make its way through both houses of Congress.

MSRB QUARTERLY MEETING: The Municipal Securities Rulemaking Board (MSRB) recently had its quarterly meeting where it discussed a variety of initiatives related to its rulemaking and improving market structure, efficiency and transparency. Of note, the Board continues its work to fulfill its mission to regulate municipal advisors (MA's). Proposed pay-to-play rules for advisors will be forthcoming in the near future, and the Board is now reviewing comments received on already proposed rulemaking related to MA's core duties and standards of conduct, compliance obligations and professional qualification requirements.

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

NORTHEAST

On May 7th, **Goldman, Sachs & Co.** priced $137 million of Children's Hospital revenue bonds for the **Massachusetts Development Finance Agency**; Aa2/AA/NR; callable in 10/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2031	5.00	3.33	+18
2034	5.00	3.54	+20
2046	5.00	3.81	NA

Notes: Hospital credits have fared well of late

MID-ATLANTIC

On May 6th, the **Delaware Transportation Authority** sold $113 million of revenue bonds to **Morgan Stanley & Co. LLC**; Aa2/AA+/NR; callable in 7/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.30	+10
2024	2.25	2.36	+4
2025	3250	2.55	+11

Notes: High-grade competitive deals attracted low yields

MIDWEST

On May 7th, **Citigroup Global Markets Inc.** priced $450 million of Toll highway senior revenue bonds for the **Illinois Toll Highway Authority**; Aa3/AA-/AA-; callable in 1/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2026	5.00	2.94	+37
2029	5.00	3.26	+32
2039	5.00	3.89	+36

Notes: This higher-rated IL credit locked in low, longer-term rates

SOUTHEAST

On May 7th, **Wells Fargo Securities** priced $26 million of sewerage system revenue bonds for the **Metropolitan Sewerage District of Buncombe County, NC**; Aa2/AA+/AA+; callable at par in 7/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	1.32	+14
2024	2.50	2.46	+16
2034	3.75	3.66	+32

Notes: Par-ish couponing 10-years and out did surprisingly well

SOUTHWEST

On May 8th, **Jefferies LLC** priced $97 million of district improvement refunding bonds & district contract tax refunding bonds for the **Harris County Flood District, Texas**; Aaa/NR/AAA; callable in 10/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2014	NRO	NRO	NRO
2025	5.00	2.58	+16
2029	5.00	2.91	-3

Notes: TX tax code had a minimal penalty on this high-grade issuer

FARWEST

On May 7th, **Piper Jaffray** priced $66 million of limited tax general obligation bonds for the **Bethel SD #403, Washington**; Aa2/NR/NR; School Bond Guaranty (Aa1); callable at par in 6/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
6/2019	5.00	1.45	+27
6/2024	4.00	2.58	+28
12/2025	4.00	2.87	+45

Notes: Sub 2.6% yield in 10-years was a positive for this Aa2 rating