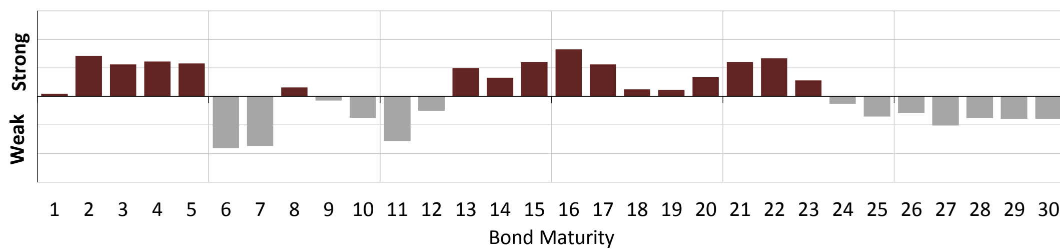
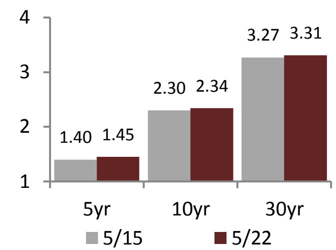
MMA Independent & Data Driven

MAY 26, 2015

MUNICIPAL ISSUER BRIEF





Heading into this week, the pricing environment for issuers is a mixed bag with opportunity in intermediate maturities while longer-dated securities may find the pricing environment not as favorable.

MARKET UPDATE

CHALLENGES PERSIST: It was generally another challenging market for issuers to access. This became quite clear as Treasury bonds improved in the latter half of the week and municipals just could not keep pace.

INVESTORS & ISSUERS: Important credit themes affect all:

- The market for **municipal bonds continued to cheapen** last week and new deals generally struggled as a result.
- Perhaps the most telling was that U.S. Treasury bonds, which tax-exempts tend to follow, actually saw interest rates lower while municipal bonds continued to struggle. **This underscores the negative themes present, which include:**
- 1) The Chicago downgrade to below investment-grade status continued to have a **ripple effect into other parts of the market** (see **Topic of the Week** on **page 3** for more);
- 2) Mutual funds that purchase municipal bonds saw a third straight week of **investors pulling money out**, which means in many cases these funds must sell municipal holdings to pay those investors back. This acts to negatively affect the secondary market, which can impact new deals as well; and
- 3) The volume of bonds that dealers are attempting to sell in secondary markets hit a 12-month high last Monday. This indicates dealers are encountering hesitant investor demand, that can **result in adjustments to higher yields among new issues.**
- Looking ahead to this holiday-shortened week, supply lessens, **which could provide some relief.**
- But, Chicago's sale of $800 million GOs will be of critical importance in the wake of the recent downgrade, and Pennsylvania $1+ billion GOs on Wednesday will challenge investor interest.

FED PROPOSES SOME MUNICIPALS HQLA: Last Thursday, the Federal Reserve announced that it would consider most general obligation bonds as high-quality liquid assets. This classification allows some banks' GO holdings to be included in the "range of assets a banking organization may use to satisfy regulatory requirements designed to ensure that large banking organizations have the capacity to meet their liquidity needs during a period of financial stress." While **MMA** has commented that this classification is not imperative to issuers' access to the market, it is helpful in the event of another financial crisis. However, market participants should still be concerned the Fed excludes more bonds than it accepts as HQLA, and that other regulators have not yet joined the Federal Reserve in this classification.

BUYERS BITES:

WHAT IS TRENDING HOT:
1) 10-15 year maturities outperform
2) PR GO, COFINA rally continues

CURRENTLY HARDER SELLS:
1) Chicagoland, Illinois
2) New Jersey appropriation

WHO IS REPORTEDLY BUYING:
Insurance companies, SMA, retail, large banks

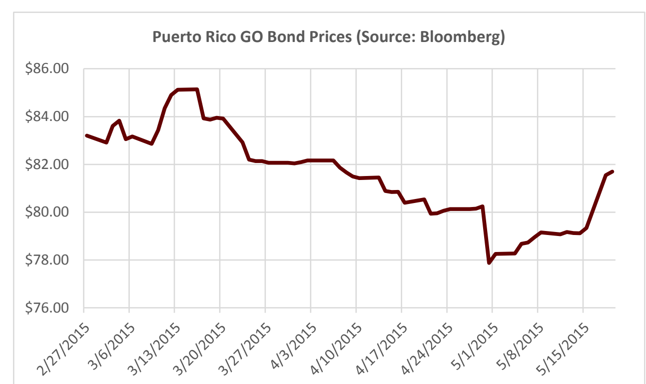


Figure 1*: Above we track the Puerto Rico bond rally from* ***Buyers Bites.*** *Note the dollar price of the GO bonds improved nearly $4.00 since the start of May as chances of legislation, which would apply a new tax, materialized. This rally occurred while the general market faced headwinds that increased borrowing costs for many issuers. This is important so as to underscore that Puerto Rico (while in name a municipal bond issuer) has largely deviated from the general market because its active investors are predominantly non-traditional (read: hedge funds). This week on* ***page 3*** *we take a look at the impact of Chicago's downgrade to the city's trading prices but also of its headline's impact on other credits which share similar issues.*

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TOPIC OF THE WEEK: CHICAGO IMPLICATIONS

CHICAGO DOWNGRADES: Two weeks ago, all three major rating agencies downgraded various Chicago, Illinois credits with the most notable move made by Moody's Investors Service putting the third largest American city's general obligation (GO) pledge below investment grade at Ba1. It was a State Supreme Court decision that sparked the move: the court unanimously rejected the state's pension reform plan—a decision that a consensus of the industry had expected. Below investment-grade becomes more problematic as the change triggers termination and accelerated repayment provisions on the city's variable-rate debt and swaps. As such, the city is coming to market this week to switch out its debt to fixed-coupons. **MMA** told institutional clients last week that we expect Chicago's credit strengths to outweigh the risks of non-payment and suggested this as a buying opportunity for sophisticated and headline resistant investors. That being said, the city has significant short- and long-term challenges with implications for all municipal issuers to consider.

WHAT THIS MEANS FOR YOU: That such an important, economically vibrant city such as Chicago is considered a junk credit by one of the major rating agencies makes for a perception problem that all issuers may have to contend with. The pension drumbeat only grows louder as it is the city's pension liabilities that drove the credit action. In the days after the Moody's downgrade, we saw significant retail selling of the city's debt—even of other Chicago credits that were not downgraded. Additionally, many of the state's own credits began to widen as many investors looked to shed any Illinois exposure whatsoever. Then, the real contagion began to occur as other municipal credits that also have large pension liabilities began to cheapen as retail accounts sold those bonds as well. Most notable was New Jersey appropriation debt but we also saw cheapening for Pennsylvania, Connecticut and Louisiana GOs, among others. With retail 'cleansing' portfolios of municipal bonds that have the perception of a future pension liability problem, those issuers—all else being equal—will see their borrowing costs increase the next time they price a deal. When Connecticut sold bonds a week and a half ago, it was forced to increase yields as much as 20 basis points before closing the account. **MMA** will be closely watching how Pennsylvania's large GO sale fares this week.

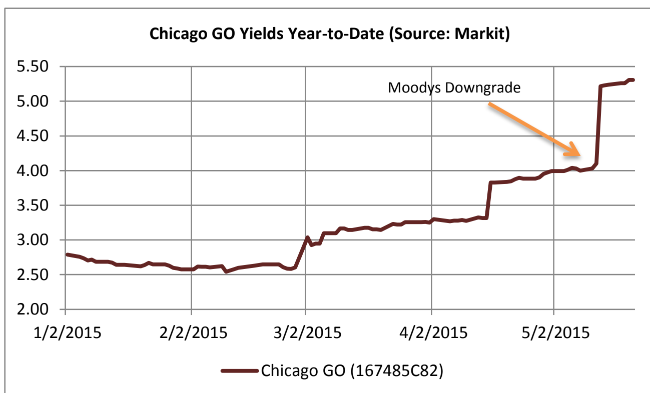

Figure 2: *The Moody's downgrade forced a 150+basis point sell-off.*

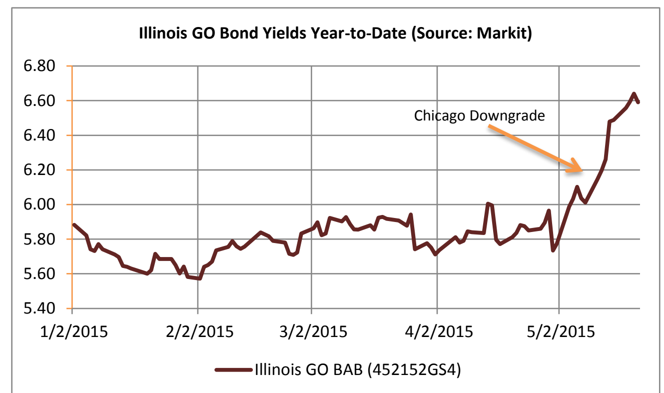

Figure 3: *The state's GO was not downgraded but its yields rose.*

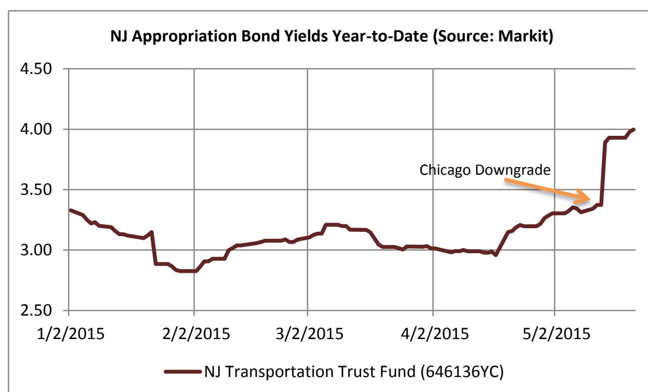

Figure 4: *Retail selling of New Jersey—because it also has significant pension liabilities forced its bonds yields to rise as well.*

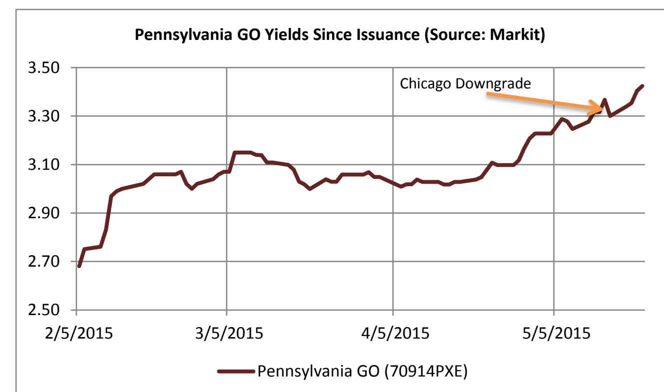

Figure 5 *Pennsylvania GO fared better but it also saw higher yields.*