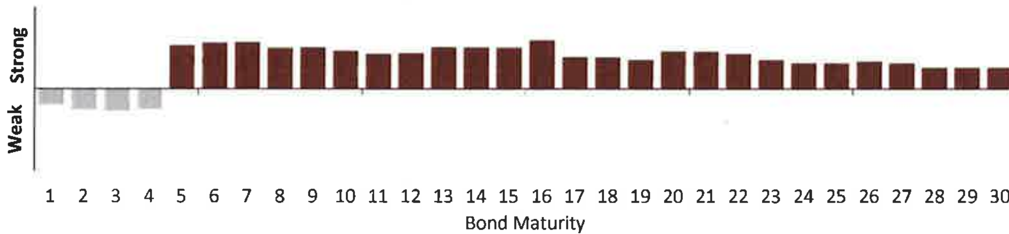
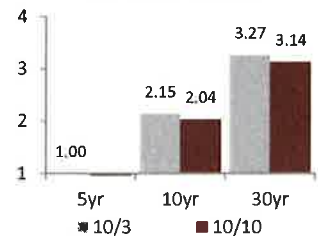
MMA The Power of Independence

OCTOBER 14, 2014

MUNICIPAL ISSUER BRIEF





Heading into this week, the strong pricing dynamic remains squarely in tact after last week's rally. Still, we do note that longer maturities were not in as strong a position as last week. The largest municipal underwriters are growing skeptical of how far the market can continue its aggressive movement to lower yields.

MARKET UPDATE

MUNICIPAL RALLY LAST WEEK: Bond markets worldwide moved into lower yield ranges last week as global economic growth is not meeting expectations. Municipalities saw very large investor interest and continued the abnormally strong start to October.

INVESTORS & ISSUERS: Market continues to appear "bullet proof"

- With the perception that the Federal Reserve is still not seeing enough growth in the U.S. economy to justify increasing its target rate, Treasury bonds rallied to their lowest yields in more than a year, **which made room for another rally in tax-exempt borrowing rates.**
- **Municipal interest rates moved to their lowest since the start of last Summer** and most issuers that were in the market saw very strong demand for their credits.
- As a result, a majority of new issues that we monitored had ample investor interest. (See **page 4** for regional deals.)
- Perhaps most indicative of investor interest in municipals was the strong demand for bonds from the **recently downgraded state of New Jersey. The state sold appropriation-backed bonds and was able to re-price bonds significantly richer** after oversubscriptions. **Stockton, California,** currently in bankruptcy proceedings, sold bonds to help finance the city's water utility.
- The interest in primary markets bled into the secondary markets that also saw a **rally of big proportions**. It was not just high-grade credits either, as lower-rated healthcare, universities and even **Jefferson County** (which recently saw a difficult court ruling get handed down) all moved into **richer prices and lower rates.**
- Large asset manager **PIMCO** has been seeing outflows from their funds after its founder was forced out. If PIMCO is a big lender to your community **this may negatively affect you.**
- This week issuance is higher than recent weeks. New York is offering a high-grade state sales tax credit that, along with Washington state's competitive GO issue on Wednesday, **will set the tone for high-grade names**. Look for large banks and insurance companies to put in large presale orders for these issues.

MORE CUTS TO BABS: Sequestration will once again **cut** federal subsidy payments to issuers of **Build America Bonds** and other direct-pay bonds. This fiscal year, the subsidies will be cut by 7.3% due to sequestration. This risk was not fully realized by many issuers who partook in BABs.

BUYERS BITES:

WHAT IS TRENDING HOT:

1) Higher issuance states (NY, CA, TX etc.)
2) AA or better GO benefit from large bank bid
3) Lower-rated healthcare, utilities benefit from funds

CURRENTLY HARDER SELLS:

1) U.S. Territories not keeping up

WHO IS REPORTEDLY BUYING:

Mutual funds, large banks, life insurance companies

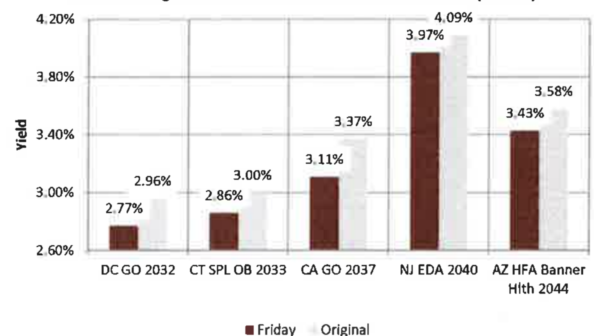


***Figure 1**: The Investors & Issuers section talks extensively about how investors are aggressively purchasing new municipal bond deals. What we are also seeing, though, is that these bonds then trade much better in secondary markets. The chart above features 5 new issues in the month of October, comparing their original primary pricing (grey columns) to where their yields were trading in the secondary market on Friday (in institutional block sizes, maroon columns). **It is always valuable for issuers to track secondary market trading.** The information assists in assessing the strength of your underwriting group. However, note that no single bond trades in a vacuum; and the broader market context is key to the initial and future transactions.*

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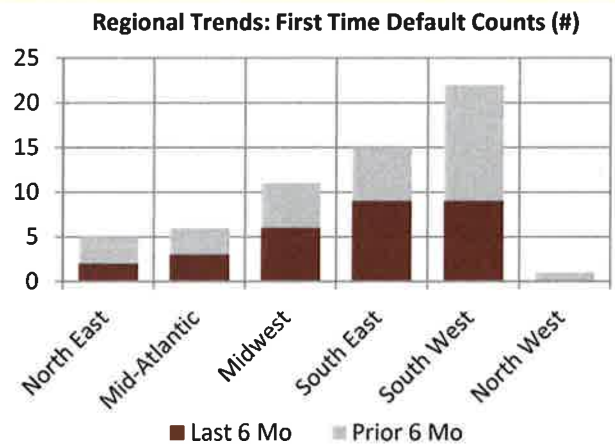
TOPIC OF THE WEEK: HQLA AND MUNICIPALS

HQLA AND MUNICIPALS – WHAT'S NEXT?: Last month, the Federal Reserve and other federal regulators released their liquidity coverage ratio (LCR), which excluded municipal bonds from the definition of high-quality liquid assets (HQLA). This HQLA designation requires the largest banks to hold sufficient amounts of these investments to cover each bank's liabilities to ease related liquidation/resolution worries. Now, it appears that the Fed is moving—propelled in part, it seems, via strong pressure from voices like Senator Charles Schumer (D-NY), the state governors and advocacy groups—to allow a segment of the municipal market into the definition of HQLA. The question is, of course, which municipal segments will be "in" and which will be excluded. Still, even if no municipals were included in HQLA designation, **MMA expects there will be little effect on near-term market prices.** Exclusion of municipals as HQLA does not mean large banks will sell their bonds or halt municipal portfolio growth immediately. Rather, it implies that, in times of severe systemic crisis—when banks' liquidity coverage ratios are approaching regulatory minimums—they will shy away from buying, or making markets in, municipals. It is again noteworthy that 4 banks hold $100 billion of the total $400 billion in bank portfolios.

WHAT IT MEANS FOR YOU: How the Federal Reserve goes on to define some municipals as HQLA and others as not HQLA is the current chapter for this issue. **MMA** expects this decision to occur sooner rather than later. <u>If an issuer eventually gets put into the 'non-HQLA' box, borrowing costs for that issuer might increase</u>. This would be because banks would now have to post more collateral to invest in affected bonds. Also, if the underwriter that is pricing your deal is a bank subject to these rules, they would have to post more collateral on any unsold balances. All else being equal, this should motivate the underwriter not to have balances. **MMA** worries that a hard distinction between issuers (such as those belonging only to large or state issuers) could affect price discrimination against small and local issuers, solidifying—and perhaps worsening—the market penalty already being assessed against these issuers. A better solution in our view would be a soft distinction, for example, allowing HQLA eligibility for "upper investment grade." Remember that in a post Dodd-Frank world, Federal regulators are not allowed to use ratings definitions anymore. "Upper investment grade" respects the municipal market's clear preference for AA-and-better-rated issuers while reducing the stigma on non-HQLA (lower rated and smaller) issuers. **MMA** also favor distinctions such as maturity (favoring 10-year and shorter bonds), sector (safe sectors versus risky), and even specialty state status. But there is also upside: municipals-as-HQLA should help keep bank inventories (and critical market-making by large dealers) available for longer periods should systemic liquidity conditions begin to erode. Also, a change could lower capital costs and boost profitability of large municipal dealers generally. For a dealer industry that has seen underwriting fee revenue fall in recent years because of lower new-issue supply (and higher costs from increased regulations), any small degree of financial assistance implies greater investment and greater risk taking by the banks, which would therefore benefit issuers coming to market.

CREDIT IMPAIRMENT UPDATE

DEFAULT TRENDS UPDATE: The end of September and start of October added just two new names to the **MMA** database of impaired bonds and one first-time defaulter. This is a change from the faster pace in defaults and impairments that had been developing earlier in September, dropping our measure of default momentum (seasonally adjusted default momentum) down to 14% (or, default incidence in the last 3 months has grown by 14%) from its August peak of 49%. This is a positive development for the industry that always faced an uphill battle when it comes to properly educating investors to the true credit stories. In the **chart to the right** we break down the number of first-time defaulters by region in the last six months and again the six months before that. First, we note that in general the same regions are trending in similar ways over the last year. The southwest and southeast are highest. Of note is that most of these defaults were associated with real estate, and non-traditional municipal bond finances—areas of historical risk in municipal finance. As we have typically seen in defaults, except for a handful of outliers, state and local government GO and revenue bonds rarely make the list.



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

NORTHEAST

10/7: **JPMorgan Securities LLC** priced $644 million of school facilities construction bonds for the **NJ Economic Development Authority**; A2/A-/A-; callable in 6/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	2.01	+101
2024	5.00	3.26	+111
2034	5.00	3.97	+94

Notes: Recent downgrades did not deter investors

MID-ATLANTIC

10/7: **Loop Capital Markets** priced $515 million general obligation and refunding bonds for the **District of Columbia**; Aa2/AA/AA; callable in 6/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	3.00	1.20	+20
2024	4.00	2.37	+22
2034	5.00	3.03	0

Notes: Recent upgrade allowed for tight pricing to the MMA 5%

MIDWEST

10/8: **JPMorgan Securities** priced $227 million of revenue bonds for the **Grand River Dam Authority, Oklahoma**; A1/A+/A; callable in 6/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	1.27	+28
2024	5.00	2.47	+34
2034	5.00	3.07	+7

Notes: Longer maturities saw lower yields in a re-pricing

SOUTHEAST

10/8: **Wells Fargo Securities** priced $102 million storm water fee revenue bonds for **Charlotte, North Carolina**; Aa1/AAA/NR; callable in 12/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.22	+23
2024	5.00	2.14	+1
2043	4.00	3.48	+24

Notes: Higher-rated paper has been seeing strong support

SOUTHEAST

10/8: **BOSC Inc.** priced $99 million unlimited tax school building bonds for the **McKinney Independent School District, Texas**; Aa2/AA/NR; PSF guaranteed (Aaa/AAA/NR) callable in 2/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.14	+15
2024	5.00	2.21	+8
2039	4.00	3.35	+17

Notes: Texas school districts have fared well in recent weeks

FARWEST

10/9: **RBC Capital Markets** priced $450 million power system revenue bonds for the **Los Angeles Department of Water and Power, California**; Aa3/AA-/AA-; callable in 7/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	1.03	+5
2024	5.00	2.10	-2
2044	5.00	3.19	-4

Notes: Second CA water deal to price in 2 weeks saw big demand