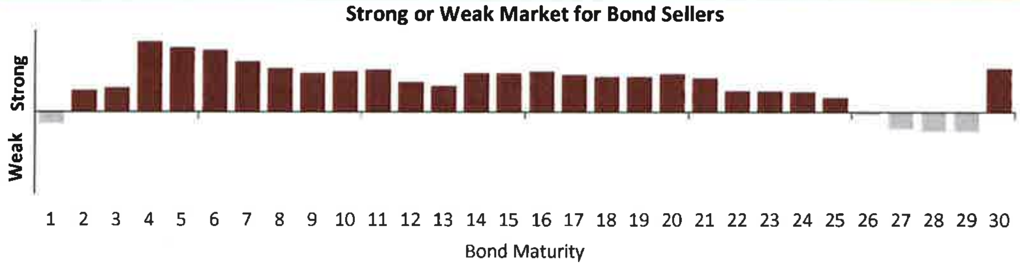
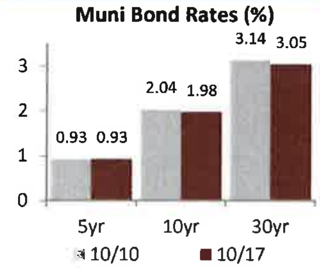
MMA The Power of Independence

OCTOBER 20, 2014

MUNICIPAL ISSUER BRIEF





*Heading into this week, the strong pricing dynamic at play all October continues to define market conditions. However, note that several longer maturities are now in the weak area **(above)** after the losses at the end of the week. Note in this week's **Buyer Bites** that longer-dated bonds led losses across the market.*

MARKET UPDATE

MARKETS WENT HAYWIRE LAST WEEK: A confluence of events last week made for one of the most volatile few days in recent memory. For the first time since mid-September, new-deals struggled and secondary selling increased at week's end.

INVESTORS & ISSUERS: Rate volatility affects all market participants

- From top to bottom, the Treasury market moved about 60 basis points last week. It started with a **massive rally on Tuesday,** but by Wednesday morning the bond markets began to shift. Most bonds **began to cheapen significantly Wednesday afternoon.**
- Municipal markets largely kept up with the volatility, ending the week with gains but most of those were attained at the beginning of the week. This means the market lost significant ground on Thursday and Friday, **which sets things up on tenuous footing to start the week.**
- Illustrating how this affected issuers, we note that New York Dormitory Authority's state sales tax deal on Tuesday received about $500 million in retail orders on $1 billion, and closed out on Wednesday with lower yields. Deals that came when things became more challenging, such as the Miami-Dade school board on Thursday, **received tepid investor interest** and cheapened yields by as much as 15 basis points before closing the account.
- This week the scheduled issuance is larger than the weekly average in 2014. There are several high-grade issuers, the state of Delaware, the District of Columbia and Seattle, which will shed light on clearing high-grade market yields, and corresponding benchmarks.
- There was a period on Wednesday morning, at the height of price volatility, when several municipal dealer firms halted all bond sales/purchases. Dealers were challenged to mitigate secondary market risk (i.e.—hedge) and an instructive example to policymakers who are reviewing market liquidity.

At the National Association of Municipal Advisors' annual conference an SEC official expressed concern that the SEC's Municipal Advisor Rule's Independent Registered Municipal Advisor exemption may not be applied correctly. The SEC stressed that for the exemption to apply the MA must be "meaningfully engaged" with the issuer. Examples of MA services being offered at low fees and without a "meaningful engagement" with an issuer have come forward and the SEC stated this situation would not meet the IRMA standards put forth by the SEC.

BUYERS BITES:

WHAT IS TRENDING HOT:

1) Investment-grade healthcare

2) Essential utility systems outperforming

CURRENTLY HARDER SELLS:

1) U.S. Territories

2) Longer–dated bonds led losses

WHO IS REPORTEDLY BUYING:

Mutual funds, relative value and hedge funds

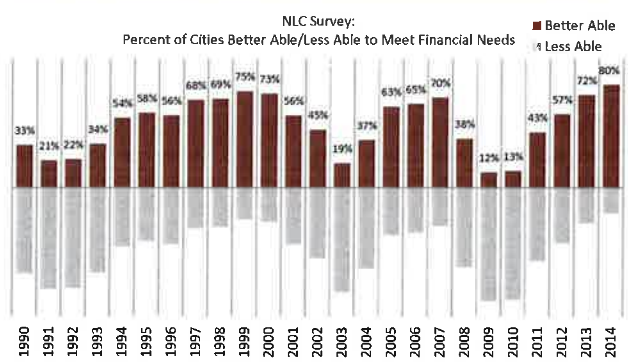


Figure 1**: This year has the highest number of cities that are positive about their ability to meet their financial needs compared to any other year going back to at least 1990. At 80%, this is now the 3rd straight year that over half the cities polled by the National League of Cities are positive on their fiscal situation. This is a good sign for the economy and suggests cities may be more inclined to borrow to meet infrastructure needs. One area where local governments may want to pay more attention is pensions, a subject **MMA** examines in this week's **Topic of the Week**.* *For more on the NLC survey, turn to **page 2.

TOPIC OF THE WEEK: LOCAL PENSIONS AS PROBLEMATIC

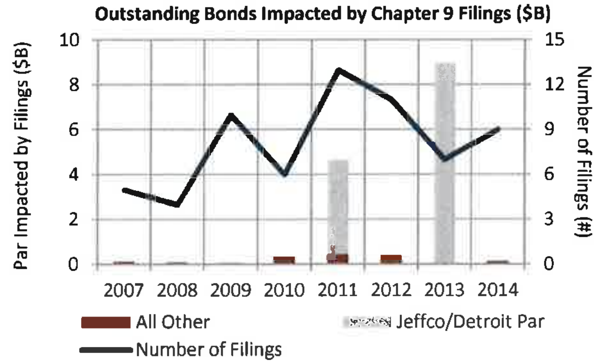
LOCAL GOVERNMENT PENSION DIFFICULTY: Pension funding has become a key credit factor when investors analyze municipal bond issuers. While the financial health of pensions is increasingly a differentiating factor in the credit quality of states, underfunding has generally not been—nor do we expect it to be—a threat to the payment of state-issued bonds. Most states have enacted some type of pension reform in recent years and more changes will likely follow. These reforms, along with the end of the smoothing of stock market losses from the financial crisis and better investment returns in recent years should help improve overall funding ratios. However, pension, and surprisingly OPEB **obligations have jeopardized the repayment of capital market creditors** for distressed local governments, especially those with access to Chapter 9 bankruptcy protection.

WHAT IT MEANS FOR YOU: Because of the paths taken in the bankruptcies of Detroit, Michigan, and Stockton, California, that impaired bondholders, municipal pension costs and unfunded liabilities are viewed much more skeptically by potential investors. Local governments, even without access to Chapter 9 bankruptcy, could make choices about what obligations to pay setting up an issue between pensioners and bondholders. Recall that default and bankruptcy are independent of each other and leave enforcement of remedies to the court system, or concessions that may prefer non-bond creditors. Consequentially, investors view local government issuers on the whole (including pension costs) with more skepticism. More investors are avoiding sole reliance on security structure that could be undermined in times of stress. This reasonably means that the costs associated with repaying public debt, pensions, OPEBs, direct loans and other important contractual relationships are being considered by investors. MMA expects that defaults and bankruptcies will remain low among local governments but investors may anticipate that there could be a potential breakdown in willingness to pay bondholders when a municipality approaches financial distress. All else being equal, **the borrowing costs for local issuers with at risk pensions will increase and may even affect local governments in states where other locals are experiencing pension-related difficulties.**

An example: California Treasurer Bill Lockyer recently commented that he expects local government access to Chapter 9 will be met with legislative changes if federal bankruptcy law is thought to permit California pensions to be impaired in bankruptcy. This comment—along with the treatment of Detroit and Stockton pensions versus bonds—crystallizes the point that state politics is a key driver of Chapter 9 outcomes. The political sensitivity of cutting pension benefits could result in a prioritization of these obligations ahead of municipal bond investors. Additionally, the stigma of bankrupt cities suggests that policymakers and regulators in Washington continue to be sensitive to "risks" in municipal investments and municipal policies, which in turn leads to possible legislative "solutions."

Still, all issuers should note that **municipal bankruptcies remain very low**. Detroit was the last city to file for Chapter 9 protection, 15 months ago. Year-to-date there have been 9 Chapter 9 filings, all of which have involved special districts and an aggregate $126 million of outstanding municipal bonds (**chart to the right**). Three of those Chapter 9s have already been resolved: two as part of prepackaged resolution plans and one had its bankruptcy thrown out. This leaves fourteen Chapter 9 bankruptcies open, and progressing in a material way. Of the fourteen, only three—Detroit, Stockton, and San Bernardino, California—involve something other than a special district or hospital.

Outstanding Bonds Impacted by Chapter 9 Filings ($B)



NATIONAL LEAGUE OF CITIES

NLC: CITIES REMAIN IN RECOVERY PHASE: The National League of Cities (NLC) last week released their Annual *City Fiscal Condition Report*. The Report detailed many variables about the fiscal health of cities, and concluded that while the worst was over, cities remain in the recovery phase. Items of note in the report include:

- Budget pressures continue to be felt from Federally unfunded mandates and increased costs and demand for services, health care and infrastructure;
- Traditional revenue sources are still in flux. While property taxes will increase slightly in 2014, the modest gains in income and sales taxes found in 2013 will plateau this year;
- 80% of the cities surveyed said they are better able to meet fiscal needs in 2014, than in previous years since the recession;
- Modest gains in general fund revenue were reported for 2013, yet are estimated to stagnate in 2014;
- For the first time since the recession, the local government workforce is growing. However, the numbers remain 500,000 less than in 2008; and,
- Fund balances are on a positive trend, currently averaged at 22%, compared to 25% pre-recession.

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

NORTHEAST

10/15: **Bank of America Merrill Lynch** priced $1.045 billion of sales tax revenue bonds for the **Dormitory Authority of New York**; Aa1/AAA/NR; callable in 3/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	0.93	+1
2024	5.00	1.89	-7
2044	5.00	2.87	-19

Notes: The largest deal of the week benefited from an early pricing

MID-ATLANTIC

10/16: **Siebert Brandford Shank & Co** priced $202 million turnpike subordinate revenue bonds for the **Pennsylvania Turnpike Commission**; A3/A-/A-; callable in 12/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2029	5.00	2.91	+52
2034	5.00	3.22	+49
2044	5.00	3.55	+59

Notes: This longer-dated deal did surprising well given conditions

MIDWEST

10/15: **Morgan Stanley & Co.** priced $217 million of Metropolitan Sewer District of Greater Cincinnati refunding revenue bonds for **Hamilton County, Ohio**; Aa2/AA+/NR; callable in 12/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.12	+20
2024	5.00	2.00	+4
2029	5.00	2.36	-10

Notes: Essential services debt has outperformed the market lately

SOUTHEAST

10/14: **RBC Capital Markets** priced $117 million non-AMT residential finance program bonds for the **Tennessee Housing Development Agency**; Aa1/AA+/NR; callable in 7/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	1.35	1.35	+43
2024	2.65	2.65	+69
2034	3.40	3.40	+58

Notes: This was one of several larger housing deals priced last week

SOUTHWEST

10/14: **Raymond James & Associates** priced $8.2 million unlimited tax general obligation bonds for the **Coahoma ISD, Texas**; A+/NR/NR; PSF guaranteed (Aaa/NR/NR) callable in 2/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	3.00	1.30	+38
2024	3.00	1.80	-16
2034	3.25	3.00	+18

Notes: The PSF market continues to drive bank demand in Texas

FARWEST

10/16: **Barclays Capital Inc.** priced $254 million correctional facilities lease revenue and refunding bonds for the **State Public Works Board of California**; A1/A-/A-; callable in 9/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.20	+32
2024	5.00	2.20	+30
2039	5.00	3.27	+37

Notes: Retail demand was high for this issuer despite market woes