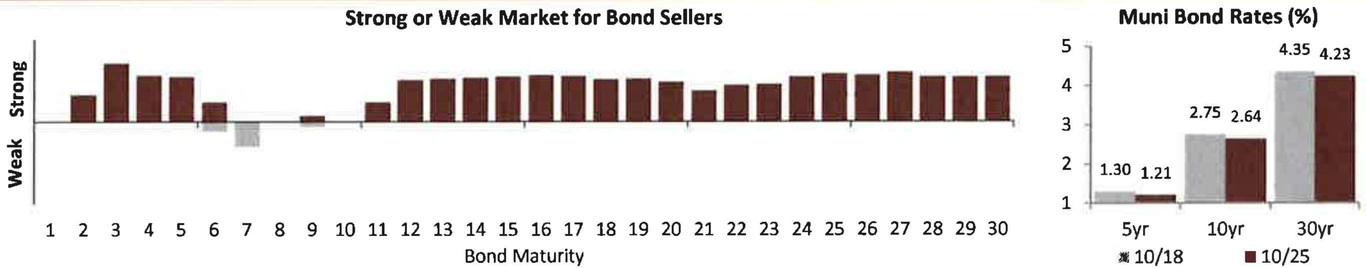
MMA The Power of Independence

OCTOBER 28, 2013

MUNICIPAL ISSUER BRIEF



Heading into this week, the same dynamic that has been at play all month persists: this is in general a good marketplace for states and localities issuing bonds. Most maturities are in the 'strong' column representing better pricing execution for issuers. There does continue to be areas inside of 10-years that are not as positive.

MARKET UPDATE

MUNICIPALS GET ANOTHER BOOST: Most bond markets traded into lower yields last week. Municipals did somewhat better than average to the advantage of states and localities issuing bonds. This week's prospects look generally good.

INVESTORS & ISSUERS: Economic data and supply helping issuers.

- **Poor economic data helps municipal borrowing rates.** On Tuesday, the federal government released a delayed monthly labor report that showed subdued job creation. This was unexpected and it caused many investors to purchase Treasury bonds. This also made for more interest in municipals and the market rallied. Most new deals that came to market were well received.
- **Caution: the rally was led by municipal dealer firms.** When dealers lead the market, as opposed to investors, **MMA** suggests caution. In the past, dealer-led market moves can struggle to have long-term sustainability.
- **Supply is manageable.** This week's municipal issuance totals about $4.3B, which is much less than the more than $8.0B that sold last week. This suggests that even though last week's move was dealer driven, there is still room to run this week.
- **Municipal bond mutual funds are still losing investors.** There have been 22 weeks of outflows of municipal bond mutual funds with funds invested in lower-rated debt losing the most. This may make it more difficult for lower-rated issuers selling bonds.
- **California retail did not show up in a meaningful way.** CA only sold 20% of its general obligation sale to individuals, which may indicate that nominal yields are too low to strongly attract retail.

PUERTO RICO & YOU

- **Puerto Rico** continued to make headlines last week as it was reported that the **SEC** is investigating Puerto Rico's saturation in tax-free mutual funds. Puerto Rico is a ubiquitous presence in the municipal market, meaning that if the SEC takes some sort of action against mutual funds that hold Puerto Rico bonds it could increase borrowing rates all around. States with higher tax rates would be effected in a larger manner.

BUYER BITES:

WHAT IS TRENDING HOT:

1) Double-A healthcare
2) Longer-dated bonds
3) Notes inside of 14 months

CURRENTLY HARDER SELLS:

1) Triple-B or lower housing
2) State-specific mutual funds
3) California retail

WHO IS REPORTEDLY BUYING:

Dealers, non-traditional firms that usually buy corporate bonds

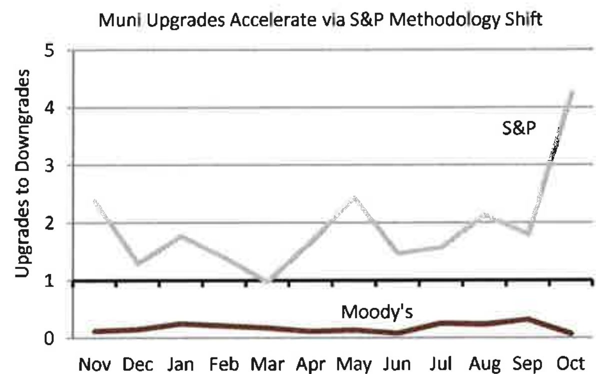


***Figure 1:** Above we show that S&P has been upgrading municipalities at a fast pace while Moody's is not. On page 3 we discuss why all issuers should be aware of the recent changes in rating agency methodologies and why market participants might not be relying on them as strongly.*

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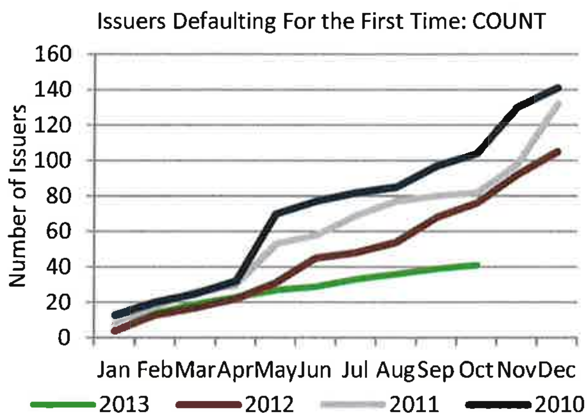
TOPIC OF THE WEEK: RATING AGENCY UPDATE

RATING AGENCIES: In recent weeks, rating agencies have indicated that they will be making changes in their approaches used for analyzing a municipal issuer's GO bonds. Unfortunately for both issuers and investors **Standard & Poor's** and **Moody's Investor Service** changes will likely result in inconsistent rating trends. Trending positive: S&P released its updated methodology for U.S local government GO ratings, which is part of the agency's efforts to make the rating assignment process more transparent and its results more comparable globally. Because of municipals' inherent positive credit factors and their strong repayment performance relative to other sectors (as demonstrated by default rates) this is a net positive for issuers. Trending negative: Moody's has refined its methodology to increase the importance of pension liabilities on rating outcomes and affirmed its negative outlook on the local government sector. Moody's also has become more concerned that local governments will look for more aggressive concessions from bondholders when they become severely distressed (albeit this is a very limited portion of the market) and try to restructure their balance sheets.

WHAT IT MEANS FOR YOU: Rating changes affect borrowing costs so being attuned to the views and changes on deck is important. Local government issuers should review each rating agency's updated criteria to see if they are likely to be affected. S&P expects that its changes will be a net positive for issuers in the sector with 30% seeing upgrades and only 10% facing downgrades. However, Moody's continues to believe that muni issuers are operating in a challenging environment. That view, combined with its increased focus on pension liabilities, will likely mean more downgrades. Issuers with larger unfunded pension liabilities and/or making less than the actuarially required contribution are more likely to be affected. Moody's worries over the potential for declining post-default recoveries could impact its ratings in the future, mainly for those issues in which default is a growing concern. Most industry participants have historically expected recoveries on defaulted local government bonds to yield at least 80% of par which may be too optimistic in today's environment. Expected recovery rates for local government debt have been high relative to other sectors in the tax-exempt market (e.g. healthcare, private higher education and project financings) which have recovery estimates around 50%. The differing views coming out of S&P and Moody's on muni credit quality should, in theory, lead larger buyers to put less reliance on the rating agencies and focus more on their own credit surveillance. As investors have to dedicate time to credit research, this cost may be passed on issuers either directly or indirectly if investors shrink their number of holdings to reduce their research costs. Issuers with good disclosure practices should fare better.

DEFAULT TRENDS & ISSUER GROUP ACTIVITY

DEFAULT TRENDS & YOU: Municipal defaults are on the downswing. The number of first-time defaulters in 2013 so far is 41 and the lowest level since MMA began cataloging defaults and problems in 2009. Based on default activity in the last four years, any full-year total below 100 implies a significant improvement in underlying default incidence (**chart below**). This is a positive for all governments that borrow in the municipal market as it implies a better context for the coming year in which investors will look at all bonds. This is especially important for issuers that may be geographically close to a defaulted issuer and risk being lumped together with that locality or authority. The chart below is a powerful statement to show potential buyers of your bonds.



NAHEFFA REPORT: DON'T DILUTE EXEMPTION

The **National Association of Health and Educational Facilities Finance Authorities** (NAHEFFA) recently released a report on how nonprofit health, educational and other charitable organizations would be harmed if Congress alters or removes the tax-exemption. If the exemption is eliminated for this sector, 300,000 jobs, $15.6B of labor income and $23.5 billion of GDP would be lost. If Congress were to enact a 28% cap on the amount taxpayers may exclude or deduct from their income, 105,000 jobs, $5.5B, and $8.3B in GDP would be lost. This follows studies done earlier this year by **NACo** (report), the **NLC** (report) and **US Conference of Mayors** (report) showing the problems and costs associated with eliminating the tax-exemption on municipal bond interest.

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

NORTHEAST

On October 22nd, **Morgan Stanley** bought a $750 million general obligation bond issuance from the **State of Pennsylvania; Aa2/AA/AA;** par call in 10/15/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2018	5.00	1.33	+3
2023	5.00	2.76	0
2033	4.375	4.40	+45

Notes: With 7 bidders and strong levels, the state benefited here.

MID-ATLANTIC

On October 23rd, **Robert W. Baird & Co. Inc.** bought $76 million of revenue bonds from the **Virginia College Building Authority;** Aa1/AA/AA; callable in 9/1/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2018	3.00	1.27	+9
2023	5.00	2.65	+13
2033	4.00	4.10	+28

Notes: This high-grade issuer benefited from strong dealer interest.

MIDWEST

On October 22nd, **Piper Jaffray & Co.** priced $35 million of revenue bonds for **Ball State University, Indiana;** Aa3/AA-/NR; callable at par in 7/1/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2018	5.00	1.41	+14
2023	5.00	3.13	+40
2032	4.50	4.50	+70

Notes: The par coupon structure in 20 years was attractive.

SOUTHEAST

On October 23rd, **Citigroup Global Markets Inc.** priced $122 million of residential finance program bonds for the **Tennessee Housing Development Agency**; Aa2/NR/NR; callable in 1/1/2023

Maturity	Coupon	Yield	+/- AAA 5%
2018	1.75	1.75	+38
2023	3.45	3.45	+72
2033	4.70	4.70	+77

Notes: The issuer re-priced bonds 5 to 10 basis points lower.

SOUTHWEST

On October 24th, **RBC Capital Markets** priced $40 million of revenue bonds for **New Mexico Finance Authority**; Aa1/AAA/NR; callable in 6/1/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2018	2.00	1.46	+17
2023	5.00	2.91	+15
2038	5.25	4.50	+15

Notes: With sub 3% yields at 10 years the issuer locked in well.

NORTHWEST

On October 24th, **D.A. Davidson & Co.** priced $2.9 million of general obligation bonds for the **Sourdough Rural Fire District, Montana**; callable at par in 1/1/2021:

Maturity	Coupon	Yield	+/- AAA 5%
2018	2.00	1.44	+22
2023	3.00	2.95	+30
2028	3.875	3.96	+50

Notes: Selling bank-qualified loans tends to draw interest.

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* Source: Thomson Financial

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"Piper Jaffray & Co. was the only top 10 underwriter to increase its business from 2012, with a par amount of $8.8 billion, compared with $8.3 billion this time last year"

– Bond Buyer, October 1, 2013