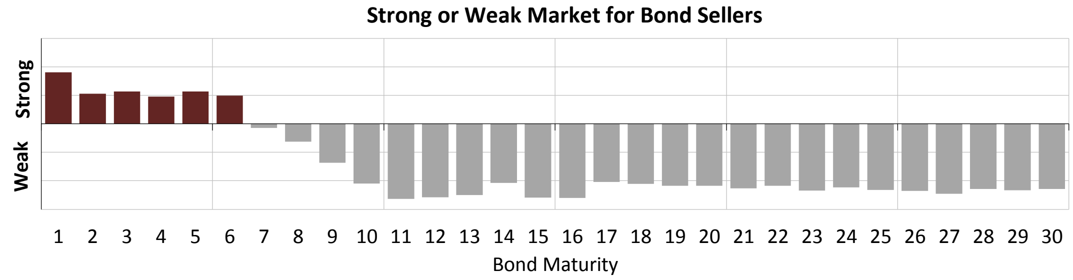
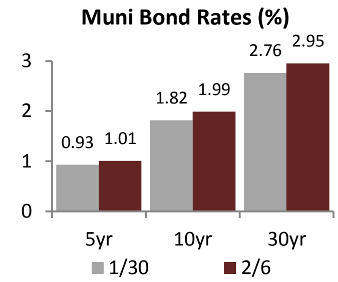
MMA Independent & Data Driven

FEBRUARY 9, 2015

MUNICIPAL ISSUER BRIEF





Heading into this week, the losses in the marketplace to start February have put the pricing context distinctly negative for most of the maturity curve. There is still opportunity 5-years and shorter, as it is here that the market was able to display resilience and investors were active.

MARKET UPDATE

FEBRUARY STARTS WITH MOST CHALLENGING WEEK IN MONTHS: Last week the U.S. Treasury bond market sold off amid stronger economic data. Tax-exempts also responded with higher yields after the releases. It was a difficult week for many issuers.

INVESTORS & ISSUERS: Last week was a difficult one for many issuers

- Generally, U.S. economic data releases were favorable all week. As a result, **most U.S. bond markets experienced a swift correction to higher yields**—municipals were no exception.
- Cumulative losses of 20 basis points throughout the 5-day period made investors apprehensive. Also, many underwriters continued to own many of the recently issued bonds—this created a situation in which **buyers and sellers of municipal bonds had difficulty agreeing on prices that eventually translated into a challenging pricing environment for many issuers.**
- For example, the $1 billion **Pennsylvania** GO competitive deal on Tuesday eventually priced at yields wider than recent norms (see **page 4** for more detail). On Wednesday, **Trinity Health Group** pulled its deal after offering the bonds to retail investors—likely because there were **simply not enough orders**.
- The nearly 15-month low yields to start the week sparked considerable retail resistance (see **Figure 1, right**). However, as yields are adjusted, investors may respond better to primary sales.
- The week's scheduled volume is near the recent average and includes another $1 billion-plus deal from a South Carolina utility company.
- A triple-A **Gwinnet County, Georgia** issue will serve as an indicator for municipal Benchmarks, as well as the state of **Washington**, which is selling a competitive issue for the 3rd time just over 3 months.

BUYERS BITES:

WHAT IS TRENDING HOT:
1) Short-call option bonds outperformed

CURRENTLY HARDER SELLS:
1) AA or better state GO
2) New York, Texas underperforming
3) Tobacco, Puerto Rico hit hard

WHO IS REPORTEDLY BUYING:
Mutual funds, large domestic banks, SMAs

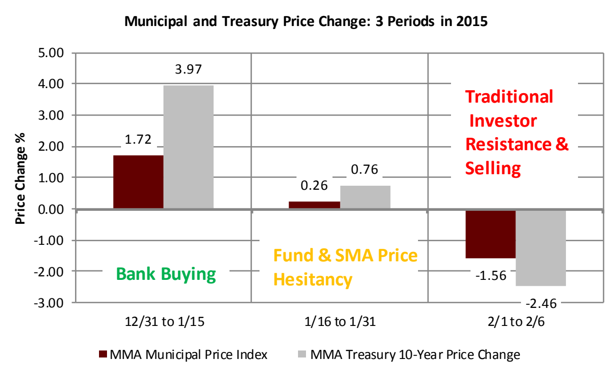


*Figure 1: The chart **above** shows 3 distinct phases of municipal market performance in 2015. The **first,** from 12/31 to 1/15, when the start of January saw very strong gains (maroon column), led by large **bank buyers.** During this period municipals could not match the U.S. Treasury market's gains (grey column). **Second**, the subsequent two weeks of January saw improvement but not to the same extent. Mutual funds, driven by large inflows, reluctantly invested at the low nominal yields. Again, municipals lagged Treasuries. **Third**, as noted in INVESTORS & ISSUERS (**left**), retail resistance to low yields contributed to losses last week, but not as great as Treasuries. Mutual funds continued to invest their inflows into the marketplace and predominantly in shorter maturities. Still the US fundamental data exerted a negative force on bonds.*

GFOA BEST PRACTICES: The Government Finance Officers Association (GFOA) released 10 new and revised best practices and advisories last week. Of note, the association revised its Advisory on Pension Obligation Bonds to include greater discussion about the risks involved with these transactions; it revised the Advisory on Derivatives urging governments without in-house derivative market expertise to refrain from using these financial products; and developed a new Advisory on Public Private Partnerships (P3s) that provides an outline of the way governments should approach these types of transactions, including knowing the risks and possible beneficial opportunities. Read more here.

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TOPIC OF THE WEEK: WHITE HOUSE BUDGET

THE PRESIDENT'S PROPOSAL: The Administration's budget for fiscal year 2016, released last week, again proposed a cap on tax exemptions and deductions—including the value of tax-exempt municipal bonds at an effective 28% marginal tax bracket—an idea that has now been circulated for 3 straight years by the President. Other important infrastructure finance policies include:

- A 6-year **reauthorization of federal highway and transit programs** paid for with a one-time, 14% tax on $2 trillion in current offshore earnings of U.S. multinational corporations;
- A **National Infrastructure Bank**, which, unlike previous proposals, would be an independent agency. The Bank would issue grants and loans to help finance infrastructure projects of national significance with a FY16 budget of $10 billion;
- America Fast Forward (AFF) bonds, which are taxable, direct-pay Build America Bonds (BABs) with a 28% subsidy instead of the original 35% subsidy. AFF bonds could be issued starting in 2016 and could be used for current refundings, short-term working capital, financing of eligible non-profits and for qualified private activity bonds (PABs)—**this is a broader use than BABs**;
- Qualified Public Infrastructure Bonds (QPIB) are an expansion of the current PAB program but with most of the private restrictions waved to **encourage more private investment in public infrastructure**. QPIBs have no volume caps and are not subject to the alternative-minimum tax (AMT); and
- The small issuer bank-qualified designation would **permanently rise to $30 million** from the current $10 million.

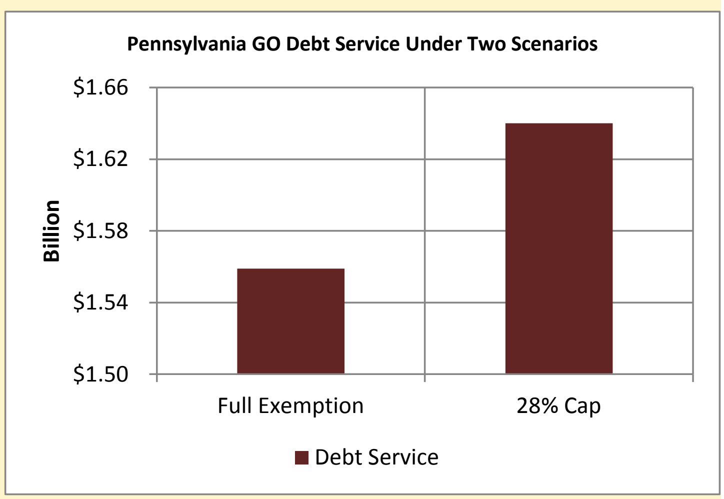
WHAT THIS MEANS FOR YOU: This is the first budget the President has had to offer a fully Republican-controlled Congress. As such, **MMA** doubts that any of these proposals will be enacted in the near term—especially the 28% cap proposal. Still, the persistence of the cap idea amplifies continued hostility to the tax-exemption and increases the odds that the exemption will be part of the tax-reform debate. **MMA** expects that if a cap is placed on the exemption, municipal bonds could lose dramatic value to investors, who would be forced to assume additional incremental rate hikes via lower bracket caps throughout the life of any bond investment (see **MODEL, below**). This means higher borrowing costs for issuers.

As for the Infrastructure Bank: this idea has been proposed by the President and various bipartisan members of Congress over the past 5 years but never enacted. Thus, there is little reason to view this as having strong potential. On the expanded bond proposals, whether it is AFF or QPIB—there is a general stigma toward enabling more debt. While there is bipartisan support for public-private partnerships (P3s), an expanded bond program will likely face opposition on the Hill. The bank-qualified increase has bipartisan support (and support from market participants across the spectrum) but also may lose out in the debate.

In the end, issuers should be wary of any of these proposals. Recall the 35% direct-pay for interest payments promised in the BABs program was cut because of macro federal budget issues, i.e. sequestration. As a result, state and local governments had to make up lost funds themselves. As **MMA** has stated in the past, current Congresses cannot control what a future Congress may legislate. Nothing is iron clad and issuers should be cautious of any proposals sold as such. (See **page 3** for more on new municipal-related legislation introduced so far this year.)

MMA 28% CAP MODEL

HOW DOES THE 28% CAP AFFECT MUNICIPAL BOND ISSUERS?
When the 28% cap was first introduced by the President, several state and local advocacy groups asked **MMA** to model out just what the proposal might mean for issuers. The **chart to the right** is the result of the model of the 28% cap on last week's $1 billion GO issue from the Commonwealth of Pennsylvania. In our model, Pennsylvania debt service would have increased by $81 million, or just more than 5% over the life of the issue, if a 28% cap were present. This is a very conservative model and we expect the cost to be higher. Here we calculate what investors would demand from an issuer in a pure economic sense if they were being capped at 28% and not allowed to benefit from the full exemption from a top tax bracket. This does not take into effect what **MMA** sees as a very credible argument that investors will demand even more from issuers as they will have to expect that this cap would continue to be lowered (if you lower it once, I expect you to lower again).



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

Three large deals that moved the market last week and why (highlighted below):

- **Pennsylvania** sold GO bonds on Tuesday to Bank of America Merrill Lynch. Leading into the deal, the market began to weaken slightly in secondary trading and most traders were looking to see how this deal fared to gauge how assertive dealers were bidding. The result: BAML bought the bonds 20 basis points cheaper than recent trading levels and it was difficult to distribute much of the deal in subsequent trading sessions.
- The **Trinity Health Group** offered bonds to retail investors and then began day 1 of institutional orders on Wednesday; but the syndicate eventually cancelled all orders and postponed the issue.
- High-grade **Virginia PSA** represented a gauge for influential market benchmarks. On Tuesday, Citi bought the bonds 16 basis points cheaper in the marquee 10-year spot—yet another sign of the challenging market environment that has evolved.

NORTHEAST

2/2: **Roosevelt & Cross** priced $15 million general obligation bonds for **South Orange-Maplewood School District, NJ**; Aa3/NR/NR; School Board Reserve Fund (Aa2/NR/NR); callable at par in 1/15/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	4.00	1.16	+22
2025	5.00	2.00	+18
2028	4.00	2.53	+45

Notes: Enhanced SD bonds amid negative headlines out of NJ

MID-ATLANTIC

2/3: **Pennsylvania** sold $1 billion general obligation bonds to **Bank of America Merrill Lynch**; Aa3/AA-/AA-; callable at par in 3/15/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.25	+31
2025	5.00	2.26	+44
2035pc	4.00	3.35	+81

Notes: Yields were much higher than recent secondary markets

MIDWEST

2/3: **Bank of America Merrill Lynch** began to price $941 million composite issue bonds in 3 series for **Trinity Health Credit Group**; Aa3/AA-/AA; callable at par in 6/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.47	+53
2025	5,00	2.40	+58
2035pc	5.00	3.00	+46

Notes: This deal was pulled and placed on the day-to-day calendar

SOUTHEAST

2/3: The **Virginia Public School Authority** sold $459 million school financing refunding bonds to **Citigroup Global Markets Inc.**; Aa1/AA+/AA+; callable at par in 8/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	4.00	1.16	+20
2025	5.00	1.98	+16
2035	3.00	3.05	+51

Notes: The 10-year spread of 16 basis points to the AAA is large

SOUTHWEST

2/2: **Denison, Texas** sold $6.3 million limited general obligation bonds to **Raymond James & Associates**; NR/AA-/AA-; callable at par in 2/15/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	4.25	1.20	+26
2025	4.00	1.85	+3
2035	3.375	2.90	+36

Notes: Denison was successful with 4% and lower coupons

FARWEST

2/2: **Bank of America Merrill Lynch** priced $17.1 million tax allocation bonds for the **Portland Urban Renewal, Oregon**; A1/NR/NR; callable at par in 6/15/21:

Maturity	Coupon	Yield	+/- AAA 5%
2015	5.00	0.35	N/A
2020	5.00	1.45	+51
2025	5.00	2.42	+60

Notes: Short-call provisions can be effective if marketed properly

BILLS FOCUS ON MUNICIPALS: While market participants are digesting the president's budget, Congress has also been at work, proposing legislation that would affect the municipal market. Sen. **David Vitter** (R-LA) introduced a bill that would prohibit the federal government (including the Federal Reserve) from providing financial aid to state and local governments or pay their obligations if they default or if default is likely (with an exception for disaster relief). The federal government is already prevented from guaranteeing tax-exempt debt, making this more of a "messaging" type of bill. Sen. **Bernie Sanders** (I-VT), introduced a bill for a 6-year, $1T infrastructure spending program (and create a national infrastructure bank), specifically for water, power and other projects. Highlights of additional spending—a 40% increase in Highway Trust Fund funding; $75 billion for passenger and freight rail, including high-speed rail and inter-city passenger projects; $12.5 billion in airport grants; $25 billion for TIGER grants; and $145 billion for various water projects. Again, while passage—or even consideration—of this bill is highly unlikely, having such significant infrastructure spending ideas out in the open helps the overall debate.