THE WEEKLY MUNICIPAL PERSPECTIVE

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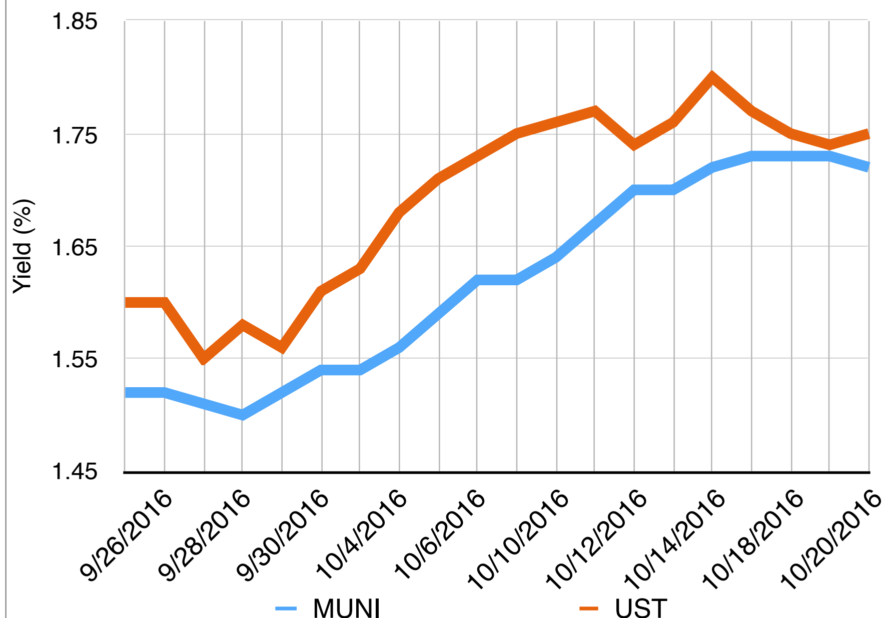
Next Week's Key Deals:

- $2.76 billion of federal highway reimbursement revenue notes for the New Jersey Transportation Trust Fund Authority, rated A3/A-/A-. Lead underwriter is Bank of America Merrill Lynch and the deal is set to price on October 26.
- $2.35 billion of taxable pension obligation bonds for the Alaska Pension Obligation Bond Corporation, rated Aa3/AA/AA, maturing 2018-2024, with term bonds in 2026, 2031 and 2039. Citigroup Global Markets, Inc. is lead underwriter and the deal is set to price on October 26.
- $675 million of Cedar-Sinai Medical Center revenue and refunding bonds for the California Health Facilities Financing Authority, rated Aa3/NR/AA-. Barclays Capital Inc. is lead underwriter and the deal is set to price on October 26.

This past week saw broader U.S. fixed-income benchmarks settle into a range while financial headlines focused on volatility in Asian markets, a falling Euro, and quarterly bank returns.

Municipal benchmarks took the settling broader rate market to allow investor digestion of one of the largest new-issue weeks in recent memory. This past week saw upward of $12 billion issued, which could help cap off one of the largest monthly issue numbers in years (more below).

Looking ahead, next week will also see a big calendar that will put 2016 total issuance at a level that could challenge the all-time high for municipal bond annual issuance.



The massive supply week was handled surprisingly well as municipal benchmarks were pretty much even on the week along the yield curve.

New Issues Continued...

- $459 million of revenue refunding bonds and taxable revenue refunding bonds for the Grand River Dam Authority, OK, rated A1/ AA-/A+. Citigroup Global Markets Inc. is lead underwriter and the deal is set to come on October 26.
- $296 million of clean water revolving fund revenue bonds for the Michigan Finance Authority, rated Aaa/AAA/NR. Bonds mature from 2017-2036. PNC Capital Markets LLC will take the lead underwriting spot.
- $273 million of senior revenue refunding bonds for the Denver Convention Center, rated Baa2/BBB-/ NR, maturing 2019-2040. Piper Jaffray & Co. will head underwriting. Deal is set to price on October 26.
- $210 million of UC Health Hospital Facilities Revenue bonds for the County of Butler, Ohio, rated A2/A/ NR. RBC Capital Markets is lead underwriter and the deal is set to price on October 25.

MARKET FUNDAMENTALS & TECHNICALS:

•**Something to consider:** Month-to-date issuance, according to *The Bond Buyer,* sits at $31.8 billion. Assuming a conservative $10 billion issue week next week we are looking at a $40 billion+ October issuance level, a monthly total surpassed for the fifth time in 2016. This happened three times in all of 2015, and only a single time (June 2012) from 2011 through 2014. **This year will likely test the all-time high of BABs-fueled 2010 total issuance of $433 billion.**

•After one year and two weeks, **the fund flow bonanza of 2015-2016 is finished** with an outflow of $136 million posted for the week ending October 19. It is not too surprising — inflows had begun to decline through October as Fed rate-hike fears permeate financial markets and as municipal supply ballooned — the market does feel a bit bubbly. So the question becomes: where do the flows go from here and how does the market respond? The big fear here is that we see a taper-tantrum event like we did in the spring of 2013.

•CSG doesn't see that happening. **Volatility is born out of uncertainty**. In 2013 the market was uncertain how a rate-rise would impact markets and as a result the municipal market saw sharp yield increases and months of outflows. The example of two months of modest outflows and a minimal market response of 2015 to the rate-rise scare is more likely the course of action for the balance of the year. We do expect yields to rise from the current point but it will occur in a more orderly fashion.

•Backing this argument was how things played out this past week. A massive new-issue volume led by benchmark-setting names like Georgia GO selling competitively along with a smattering of lower-rated names was generally well-received. **Were some deals priced to-go?** Absolutely, but the deals were done and leading benchmarks were generally even on the week.

•That this occurred with fund outflows is even more compelling. Relative value did offer something as exempts underperformed taxables as the week progressed and likely increased the amount of foreign participation that we have seen over the last few months. Note that Georgia GO in 10-years came at 1.71% and 1.74% in its two competitive series — **nearly even with the U.S. Treasury rate in that same tenor.**

•**Looking to next week:** As noted above, supply will exceed the $10

billion market in the coming week. The largest two sales will be $2.7 billion New Jersey Transportation Trust Fund bonds that have seen spreads widen considerably over the last year and an Alaska taxable pension obligation bond of $2.3 billion that has been threatening to price for the better part of the month.

- Of interest is the 104 scheduled deals next week of a size less than $100 million (according to Ipreo). This is an elevated figure for any week and the plethora of credits (many of which are on the lower part of the spectrum as high-yield continues to flow and a take advantage of the worldwide rate environment) will challenge the buy-side in deciphering credit and making investment decisions. This should make for some advantageous investment opportunities for buy-and-hold investors with the right credit diligence.

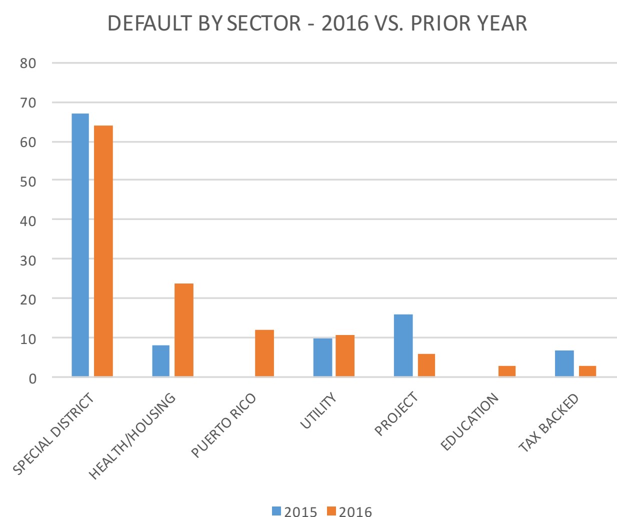
INDUSTRY FOCUS:

Fewer Covenants, More Defaults?

A Reuter's article on October 11 with the headline, "With soaring demand come weaker assurances for U.S. municipal investors," highlights a longstanding trend in the municipal market: investor protections erode during periods of high investor demand, low supply, and declining yields.

In 2016, the market is again in another such period as municipal inflows surge, especially for high-yield funds. As general government issuance continues to lag inflows, issuers in risky sectors, such as health care, retirement, land-secured and charter schools, are taking advantage by issuing riskier debt with weaker covenants and protections, such as debt service reserve funds. The article, which quotes CSG partner Joseph Krist, states that "covenant light bondholders have fewer tools to intervene…or take other corrective action earlier."

What will fewer tools mean for you? CSG has been tracking and commenting on a rising number of delinquencies in recent editions of Perspective. Reflecting the trend of diminished reserve fund requirements, the data clearly shows a rise in debt service payment delinquencies and decline in reserve draws. Among other consequences, issuers have less time to correct problems that would be corrected given the benefit of reserves. CSG has opined that these delinquencies, if not remediated, may translate into higher defaults in coming months and, possibly, years.



Are defaults becoming more common? Only time will tell as these deals ripen. What we do know now is that the **amount of delinquencies in 2016 has reached a record level, 193, 33% above last year.** Prior to this year, the highest number of delinquencies through August was 154

(in 2010). CSG will continuously monitor the trends. The 2016 year-to-date default data indicates that defaults in in two risky sectors — special districts (also known as land-secured) and project financing — have dropped while the healthcare and housing sectors show increases.

AN INVESTING PERSPECTIVE ON PUERTO RICO

As the Puerto Rico debt crisis has unfolded, there have been many suggestions about how to fix the Puerto Rican economy. In the context of the debtor/creditor relationship, the primary focus has been on the role of debt restructuring. There has not necessarily been enough discussion of this restructuring as just one of many interrelated components that would make up a plan to create a long-lasting economic environment which benefits all of the Commonwealth's stakeholders — residents, businesses, creditors, and the government.

This reflects the fact that the problems have too often been looked at through antagonistic points of view. The fact is, though, the interests of business, the residents, the creditors, and the government are the same. They are in effect one team with each representing a player playing their position with its individual responsibilities within the concept of a single goal.

Unfortunately, it appears that Puerto Rico doesn't grasp this reality. In September 2015, Puerto Rico released a Fiscal and Economic Growth Plan in which it estimated it could pay up to $4.1 billion to pay for $18.2 billion debt service due from fiscal 2016 to fiscal 2021. However, today Puerto Rico is now saying it will be not be able to pay any of the debt service and, even so, would be left with a deficit even without paying the debt service.

Without outside investment in debt issued by the Commonwealth and its various entities, none of the economic goals of the Commonwealth and its people can be achieved. For Puerto Rico to rebuild its economy and credit, a serious governmental and political environment is required. As of the moment, that does not exist. The Garcia Padilla administration has made it abundantly clear that it is bankrupt in terms of ideas, practicality, and courage. Its latest presentation to the Promesa fiscal oversight board was simply not a serious proposal. It follows on its policies grounded in the crudest forms of populism and disrespect for established institutions. The trust which has been so cavalierly discarded will not be easily recovered but the exit of the current administration and its mindset will be a constructive start.

GUAM

Meanwhile, as noted above, with investors looking for yield and diversity, territorial issuers have some interest. So we look at the Guam Power Authority. It shares many characteristics that have proven problematic in Puerto Rico, but also has its own characteristics to offset those negatives.

Guam power Authority is rated Baa2 with a stable outlook. GPA's outstanding senior-lien bond rating reflects GPA's monopoly position as the sole provider of electricity services to the Guam customer base. That base includes residential, commercial, and Guam's governmental customers, in addition to the U.S. Navy, the authority's largest customer. The rating recognizes the authority's financial and operational resilience since an August 31, 2015, fire idled two of its most efficient generating plants. Contrast that with the impact on PR of a fire-related incident. The rating also reflects GPA's improving debt service coverage and liquidity levels relative to its Baa-rated peer group. This has occurred in spite of a declining sales environment.

The local economy remains highly dependent on tourism and U.S. military spending. Fuel oil remains the virtually exclusive fuel source, but GPA is working toward increasing fuel diversity through a mix of renewables, battery storage and construction of a combined cycle plant with dual-fuel capabilities. This plan is motivated by increasingly stringent Environmental Protection Agency (EPA) requirements, which the authority is currently negotiating. The rating also considers the dependence of the island's economy on historically volatile international tourism. Economic conditions in Japan tend to have a significant effect on tourism levels. The lack of transfer payments to the general fund of the government of Guam is another positive factor.

SEC ENFORCEMENT IN FY 2016

The Securities and Exchange Commission's (SEC) Office of Municipal Securities coordinates its activities and administers SEC rules, among other things and it annually releases information regarding enforcement actions, exposing financial reporting-related misconduct by companies and their executives. This week, the SEC reported a new single-year high for SEC enforcement actions for the 2016 fiscal year that ended September 30. In this period, public finance market actions included enforcement actions against 14 municipal underwriting firms, various individuals, and 71 issuers for violations.

Among the 71 municipal issuers, 2016 featured a first-of-its-kind trial victory: the first federal jury trial by the SEC against a municipality (**Miami, FL)** and one of its officers for violations of the federal securities laws. (We reported on this in last week's Perspective.) Additionally, the SEC charged **Ramapo, N.Y.**, its local development corporation, and four town officials who allegedly hid a deteriorating financial situation from their municipal bond investors; charged **California's largest agricultural water district**, its general manager and former assistant general manager with misleading investors about its financial condition as it issued a $77 million bond offering; and charged a municipal advisor, its CEO, and two employees for breaching their fiduciary duty.

It's clear that the SEC is taking a much more hard-handed approach to the municipal market, also given its decision last week on the liquidity rules for mutual funds, including those that invest in municipal bonds. We at CSG have maintained that these rules will increase the cost of investing in a mutual fund as these entities have extra diligence procedures to understand the liquidity of their investments in a different manner.