THE WEEKLY MUNICIPAL PERSPECTIVE

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Next Week's Key Deals:

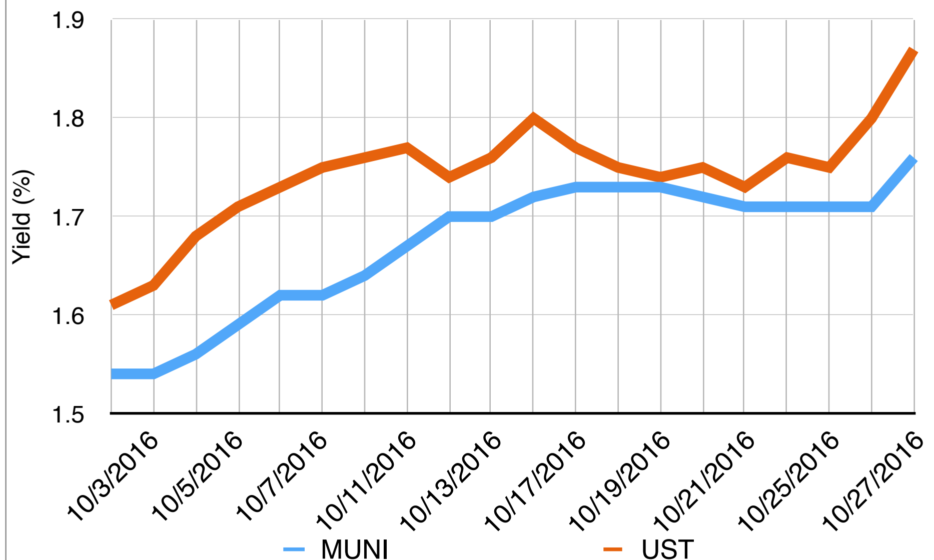
- $1 billion of Chicago International Airport General Airport revenue refunding bonds for the City of Chicago, rated NR/A/A. Bank of America Merrill Lynch is lead underwriter. The deal will come in three series; $28 million of AMT bonds, $479 million of non-AMT and $548 million of non-AMT.

- $782 million of consolidated bonds for the Port Authority of New York and New Jersey, rated Aa3/AA-/AA-. Citigroup is the lead underwriter.

- $230 million of junior-lien wastewater system revenue refunding bonds for the City of Phoenix Civic Improvement Corporation, rated Aa2/AA+/NR, maturing 2017-2035. Morgan Stanley is lead underwriter.

This past week saw U. S. fixed-income markets extend the October correction into higher yield ranges. On Thursday, the Treasury 10-year yield moved well beyond the 1.8% ceiling (see **chart** below) and into new technical territory. This has largely been based on economic indicators that continue to point to a Fed rate-hike before the year is out. Today's G.D.P. number beat expectations.

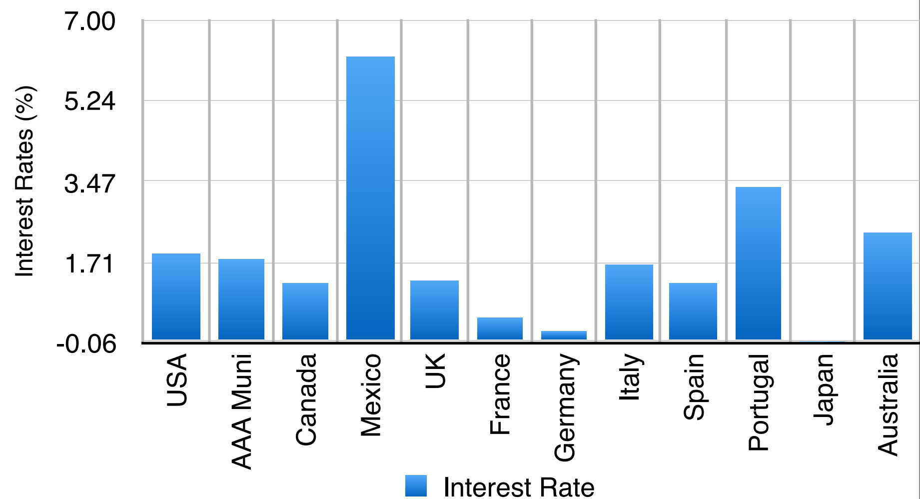
Municipal benchmarks also continued to move into cheaper ranges but last week's theme continued: a relatively resilient marketplace given the massive amount of bonds issued in the primary market.



It wasn't until Thursday that municipal yields began to really fade into the Treasury sell-off. This outperformance to taxables was impressive given the supply in the municipal primary market that surpassed $28 billion over the last 10 business days.

MARKET FUNDAMENTALS & TECHNICALS:

- **Something to consider:** With German bunds set to have their worst monthly performance this October since 2013 **making the headlines**, this could have some implications for U.S. municipal bond markets. Just last week news of Japan's Mitsubishi bank selling municipal bonds to Japanese investors (irrespective of the tax-exemption) came on the tails of Fed data showing an increase in foreign ownership of municipals. This is not surprising given the world-wide rate picture (see **chart below**). This compressed rate environment cannot last forever and with the growing consensus of a U.S. rate-hike this year and better European data (and a mitigated Brexit fall-out thus far) growing expectations for similar Central Bank behavior elsewhere, **the times of increased foreign municipal investments could be nearing an end.**



- Still, a review of the chart to **the right** shows that at this point, municipal bonds offer significant value versus most other high-grade sovereign debt markets. The supply this week was managed extremely well given volume of late and to a certain extent, foreign entities were in the mix.

- We point to a $2.7 billion **New Jersey Transportation Trust Fund Authority** that was bumped as much as 10 basis points while pricing on the back of a $28+ billion new-issue calendar over the last two weeks. It then broke in secondary market trading another 10bps better. And this is a credit that has seen spreads blow out over the last year and a half.

- We also noted several recently issued deals (Georgia GO, Connecticut GO, Robert Woods Health, to name a few) trade much better in secondary markets throughout the week, **indicative of this resiliency** but also of some of the larger deals of late priced to-go given the broader technicals.

- **Mutual fund flows reversed last week's minor outflow** to post a modest inflow figure of $335 million, according to Lipper. Funds that invest in high-yield credits saw inflows after two weeks of outflows.

- **Looking to next week:** Supply remains elevated but not to the same extent that we've seen recently. We see around $9 billion coming to market led by a $1 billion Chicago airport revenue refunding bond deal. Given the end of the week's outperformance, **expect modest municipal losses Monday and Tuesday.**

INDUSTRY FOCUS:

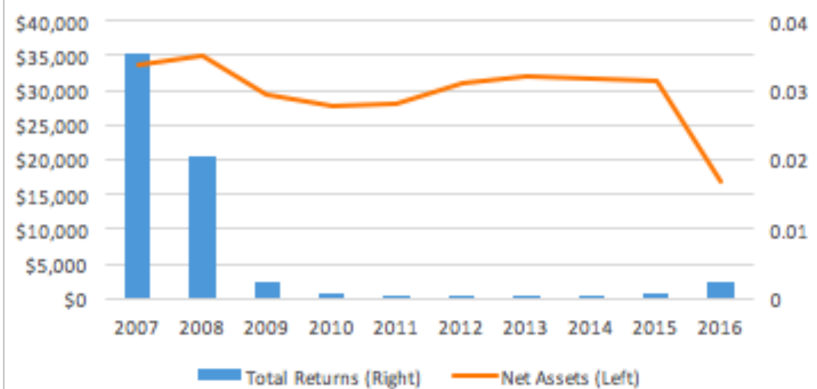
The Unwind of Tax-Exempt Money Funds — So Far, So Good

The short-end of the municipal market continues its descent. This market, made up of an alphabet-soup of securities — VRDNs, TOBs, TANs, RANs and BANs — that, in its heyday, eclipsed $500 billion of assets. Tax-exempt funds assets began 2016 with $266 billion and, as the descent has accelerated, now total $127.64 billion (as of Oct. 17) and appears destined to soon breach the $100 billion mark in the near future.

Date	Institutional ($M)	Retail ($M)
06/08/2016	45,739	160,861
10/19/2016	4,271	123,669
	-91%	-23%

The chief drivers of this process have been low interest rates, money fund unprofitability (i.e. fee waivers), lack of organic supply, and, most recently, Securities and Exchange Commission (SEC) reforms, effective October 1. The new rules were designed to prevent future runs on money funds, which act like checking accounts but have been called "shadow" banks because they are largely unprotected by FDIC or deposit insurance. Today, retail municipal money market funds now have the potential for liquidity fees and redemption gates that will penalize investors attempting to sell shares of a money market fund during periods of extraordinary market stress, and possibly make it so that investors are unable to redeem shares at all. As the shown (**table above**) assets in tax-free money funds for institutional investors have rapidly declined and will soon cease to exist.

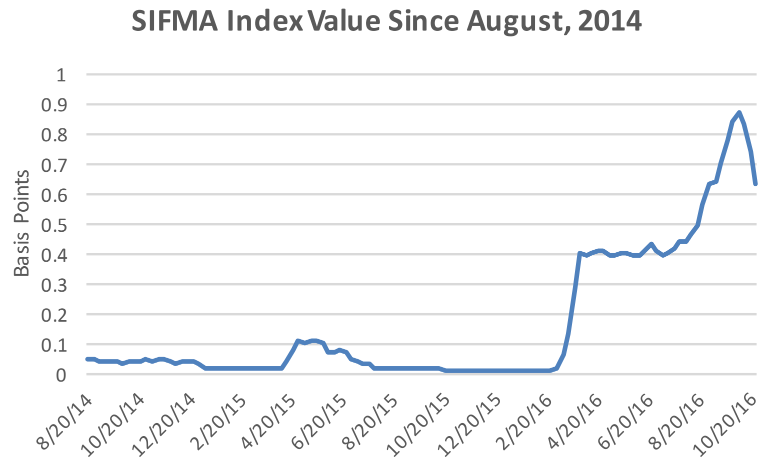
To date, the decline has been relatively orderly. Buyers of short paper like money managers such as Fidelity (**graph right**), Vanguard and Federated appear to have weathered outflows without incident. The firms have largely transitioned shareholders to other investment products as the October 1 SEC reform date approached.



On the supply-side, many municipal note issuers who benefitted from the low-rate environment have been converting floating-rate debt into long-term, predictable obligations. For instance, in its recent annual financial analysis, Chicago highlights the conversion of floating-rate GOs to fixed and the elimination of all non-airport swaps to reduce risks liquidity crisis, triggering defaults on swaps and bank support on credit lines and floating-rate bonds.

What has been concerning is the jump in yields as the new SEC rules approached. In 2016, the SIFMA Municipal Swap Index rate (an index of 7-day average maturity) has now spiked significantly twice: in

March from a one basis points to 44 basis points, then again in October to 87 basis points on October 5. **(graph right)**



The downward shift of the both supply and demand curves has caused some short-term yield disruption, but appears headed toward normalization as this market organically adjusts. While something of a shock from the last seven or eights years, issuers such as the States of California, Texas and Massachusetts have continued to retain a presence on the short end, and will undoubtedly remain loyal to the short-end going forward.

Looking forward, the unwind of tax-exempt money funds appears to be going smoothly but likely will be more challenging for some firms than others, for the following reasons:

- **Performance.** Some firms are consistently more aggressive, buying longer-dated securities and extending out for yield, a strategy that has been costly with the SIFMA spike. Fidelity's $15.8 billion Municipal Money Market Fund has 63.53% in Variable-Rate Demand Notes (VRDN) duration of Weighted Average Maturity (WAM) of 40 Days compared to Vanguard's $15.8 billion Tax-Exempt Money Market Fund has maintained 86% of its assets to VRDNs and considerably shorter WAM of 31 days.

- **Credit.** Money market funds purchase securities of widely varying credit strength. The SEC's standard that asset managers determine "minimal credit risk" allows asset managers broad latitude in what securities to purchase. Rating agencies are of little help because many issuers can bypass this process and sell unrated securities to fund managers. Unloading problem credits could be problematic for unprepared funds.

- **Expense ratios.** For nearly 10 years, most funds had been waiving fees, which has made our expense advantage less visible to the investor. However, as yields have risen many fund companies are lowering fee waivers or possibly in some cases charging their full stated expense ratios. The expense ratio benefit will begin to make more of a difference going forward.

- **Purpose.** Certain firms use money market funds as default "sweep accounts" where excess cash in shareholder accounts is automatically swept into money market funds at the close of each business day. These firms are finding it far more difficult to gain shareholder consent to transition out of tax-exempt funds.

HEALTHCARE SECTOR: NEW ISSUES

We have commented on a number of instances where the consolidation of hospitals and systems reflects a trend in that direction in response to the Affordable Care Act (ACA). Of course, there are always exceptions to any trend. One of these is reflected by Cedars-Sinai Medical Center's (CA) which brought a $677 million revenue and revenue refunding bond new-issue this week. The deal priced Wednesday with the 10-year coming at 2.04% with a 5% coupon.

Another important consideration for a hospital's bond credit under the ACA is revenue sourcing. Low government funding dependence can be a strong factor in favor of a credit. Like Cedars' case, there are exceptions as a government-dependent hospital can overcome this liability and improve ratings. Temple University Health System, the largest provider of Medicaid-funded healthcare in Pennsylvania, represents such a case. CSG looks at the circumstances behind each in the space below.

CEDARS-SINAI MEDICAL CENTER

Cedars-Sinai via the California Health Facilities Financing Authority issued Revenue Bonds in an aggregate amount of $677 million. The Series 2016A bonds are expected to mature in 2036 and the 2016B bonds in 2039. The new-money portion of the bond issue will finance the purchase of an office building currently being leased by CSMC. The purchase will eliminate an annual operating expense for rent of $14 million.

The bonds are secured by gross revenues of the Cedars-Sinai Medical Center (excluding the Foundation and Greater Valley MSO, which are a small portion of overall System revenue). The debt service coverage ratio test is 1.1x and there are no covenant restrictions on additional debt, or additional financial covenants. This is in keeping with current market trends.

Cedars-Sinai is a well-regarded academic medical center located in Los Angeles. The organization operates more than 800 beds on its main campus, generating about 50,000 admissions annually. Cedars-Sinai maintains a number of teaching and research programs and is nationally recognized in many service lines. It is the major teaching hospital for the UCLA Medical School. As a major research facility it is currently conducting more than 1,100 research projects.

Cedars is able to maintain itself as a "stand alone" facility through its size, strategic location, and wide range of services, it is able to provide at a high level. It maintains strong occupancy levels of 80%. Revenues are derived primarily through privately insured patients, with government payers generating only 30% of revenues. MediCal represents only 5% of revenues. Cedar's status as a significant teaching and research institution generates a higher level of patient acuity, which favorably impacts reimbursement rates.

Moody's Aa3 rating reflects multiple factors including Cedars-Sinai's large size and strong reputation for clinical services and research, excellent financial performance that has allowed the organization to deleverage significantly over the last several years, and strong and improving balance sheet metrics. The

stable outlook reflects an expectation that Cedars Sinai will continue to grow patient volumes and revenue, and that the organization will continue to generate strong operating performance and cash flow.

TEMPLE UNIVERSITY HEALTH SYSTEM

Temple University Health System in Philadelphia is the largest provider of Medicaid-funded healthcare in the Commonwealth of Pennsylvania. This would have been a challenge under any circumstances but the first years of the ACA occurred in an environment where the state administration in place was politically against using the opportunity provided by the ACA to expand Medicaid. So Temple faced an effective "double-whammy" as it attempted to maintain its credit standing.

So it says something about the System's management that Moody's Investors Service announced an upgrade to Ba1 from Ba2 on Temple University Health System (TUHS), PA, $507 million of rated debt issued through the Hospitals and Higher Education Facilities Authority of Philadelphia. Moody's also assigned a stable outlook.

The upgrade to Ba1 reflects durability of TUHS' financial turnaround with a second consecutive fiscal year of marginally profitable operating performance. The rating also acknowledges the health system's large size, clinical diversification, its role as a safety net provider for the City of Philadelphia, as substantiated by historically sizable funding from the Commonwealth, and close working relationship with Temple University. The rating remains constrained by still modest margins, above-average Medicaid exposure, heavy reliance on supplemental funding, a highly leveraged balance sheet relative to operations and cash, and an especially competitive market that continues to consolidate.

Clearly investment in the TUHS credit involves a taste for risk but it shows that strong management can overcome even the most challenging of credit environments.

P3s IN VIRGINIA

The Commonwealth of Virginia has been an active participant in the P3 marketplace as it attempts to find creative ways to finance the road development and expansion needs of its growing population. These efforts have met with mixed success. News this past week updates the status of these projects.

One will represent a failed effort, at least in terms of its municipal bond market experience. Globalvia has been named as the preferred bidder for the Pocahontas Parkway in Virginia, valued at $600 million. This is the Spanish firm's first acquisition in the North American market. Financial close is subject to the Virginia Department of Transportation's (VDOT) approval, which is expected sometime this fall. The transaction is slated to reach financial close before the end of the calendar year. The concession period will end in 2105.

The Pocahontas Parkway had been owned by Macquarie, and a consortium made up of TPG and Citigroup. The Macquarie unit acquired TPG and Citigroup's stake in August 2015 for about $400 million. That transaction occurred after initial operating results were not robust enough to cover debt

service on municipal bonds issued for its construction. This acquisition will have no effect on the public traveling the Pocahontas Parkway.

On October 11, 2016, VDOT and VAP3 received two proposals from two private sector teams — Express Partners and I-66 Express Mobility Partners — to design, build, finance, operate and maintain the I-66 Outside the Beltway Project. Proposals are under review.

The Department intends to announce the successful proposer at the end of October 2016, with commercial close expected at the end of December 2016. Construction is anticipated to begin in 2017.

Given the proposals by both presidential candidates, expect private capital to play more of a role in public infrastructure in the next few years. Both Republican nominee Donald Trump and Democratic nominee Hillary Clinton, have proposed involving more private money in public infrastructure, though their plans are not similar on how to incorporate it. CSG will provide more insight into the municipal market's role in the election in a special edition next week.