THE WEEKLY MUNICIPAL PERSPECTIVE

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REPORT PREPARED BY:

ROBERT DONAHUE

JOSEPH KRIST

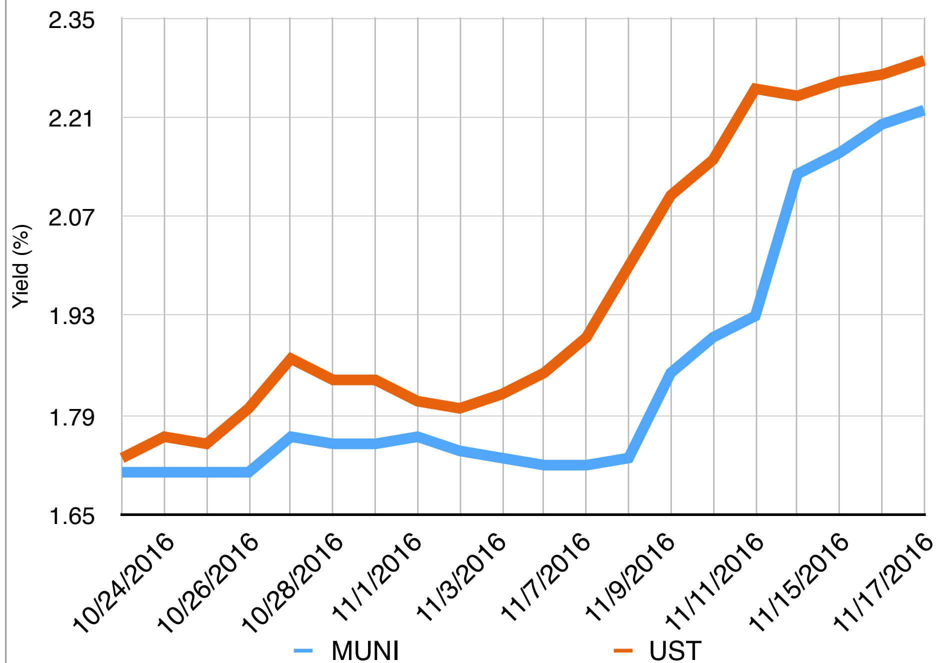
REBECCA SOBELMAN

LYNNE FUNK POSNER

MATTHEW POSNER

This past week in fixed-income saw what will likely be referred to historically as the Trump-Tantrum. Monday was one of the most difficult trading days in recent history. Inflation, tax-changes, Fed-Hike — you name it — all came together to accelerate the previous week's losses. While rates did stabilize somewhat in the latter half of the week, the market now exists in a completely different interest rate range.

Municipal benchmarks followed taxable losses, with early reads on Monday showing cuts to the scale of more than 20 basis points. Secondary selling pressure was the largest in history (**more below**) and the fund outflows this week cannot be ignored.



U.S. bond markets sold off in the largest single-day fashion since taper tantrum in the early summer of 2013.

NEXT WEEK'S KEY NEW DEALS:

- $223 million of general obligation bonds for the State of Mississippi, rated Aa2/AA/AA+. Morgan Stanley & Co. is lead underwriter.
- $186 million of Valley Medical Center limited tax general obligation refunding bonds for the Public Hospital District No. 1, WA. Morgan Stanley & Co. is lead underwriter.
- $141 million of unlimited and limited tax road bonds for Montgomery County, TX, Aaa/AA+/NR. Wells Fargo Securities is lead underwriter.
- $97 million of AMT and non-AMT homeowner mortgage revenue bonds for the State of New York Mortgage Agency, rated Aa1/NR/NR. JP Morgan Securities LLC is lead underwriter and the deal is set to price on November 22.

MARKET TECNICALS/FUNDAMENTALS:

•**Something to Consider:** This previous Monday saw municipal market participants put $2.6 billion out for the bid on the Bloomberg platform — **the largest single-day figure ever** (the data goes back to 1996 — it is very difficult to conceive a pre '96 day that would have surpassed this volume). This exceeds May 2013 levels and it is difficult to overestimate the pressure this put on a single trading day.

•Part of this pressure was a $3 billion outflow from mutual funds this week, according to Lipper. This is the largest single-week outflow in more than three years and we expect outflows to continue. There is a broader shift in assets occurring as a result of the U.S. election. The headline focus in on economic expansion and inflation, neither of which are good for bonds and **outflows could persist through year-end.**

•Pricing challenges accompanied the volatility. Several of the larger deals of the week were postponed (NY Tobacco for one, put on the day-to-day calendar) and others saw significant price cuts.

•New Jersey was downgraded one-notch to A-minus this week, marking a continued waterfall of downgrades for the state under Governor Chris Christie. The market response was mute as spreads for much of the state's outstanding appropriation-backed debt and others has widened considerably over the last 20 months.

•It's not all bad, though. Retail interest emerged in the latter half of the week as markets settled down. High levels for some credits — not seen in more than 12 months — attracted an investor who had been disinterested over the last few years.

Next week's calendar is manageable in terms of size, with the help of Thanksgiving. This, however, could very well be a tipping point with multiple weeks of fund outflows. Further, bank buyers of municipals will likely pause their buying programs until they get a better sense of Trump-inspired legislation focused at encouraging traditional bank lending to spur the economy. **Much of this legislation would incentivize local economically oriented lending versus municipal bond purchases. This is a big point and we will delve further into this topic in the coming weeks.**

INDUSTRY FOCUS:

PUERTO RICO: COFINA BONDHOLDERS SHOULD SELL BEFORE IT'S TOO LATE

When something seems too good to be true, it usually is, goes the old adage. For years, municipal bond investors garnered handsome returns from Puerto Rico's triple-tax-exempt, high-yielding bonds. The island's solid ratings and bankruptcy-proof credit was simply irresistible to investors, who treated the island's debt like a blank Scrabble peg and used it freely, despite clear warning signs.

In 2006, after a crippling government shutdown, with a plunging economy (after the phaseout of Section 936), and looming deficits, the Governor Acevedo Vila capitalized on widespread investor complacency. With help from a variety of advisors experienced with securitization and carve out bonds, the Sales Tax Financing Corporation (COFINA) was created. This structure enabled Acevedo Vila and his successor, Luis Fortuno, to avoid tough choices and offload the risk onto insatiable bondholders. For the next seven years, investors bailed out the island's feckless leadership, shelling over billions of bond proceeds to plug deficits.

COFINA achieved high ratings based on allegedly secure security interest in the pledged lockbox-ed sales tax revenues despite its lack of validation and ascending debt-service structure, rarely-used for a special tax bond. The bonds were structured to garner maximum proceeds using everything but the kitchen sink: senior/sub structure, swaps, zero coupon bonds, and balloon payments. While it lasted, the scheme was a boon for Puerto Rico's political leaders, the island's team of financial advisors, lawyers, and investment bankers, and, most critically, yield-starved performance-compensated investors.

What COFINA's investors largely refused to acknowledge, however, was a troubling provision in Puerto Rico's Constitution that explicitly states first "available resources" belong to general obligation (GO) bondholders. The question of whether and how Puerto Rico's SUT was not an "available resource" subject to clawback, troubled some astute investors, as well as Puerto Rico's long-standing bond counsel firm (since 1936, Sidley Austin, which resigned over the unwillingness of Puerto Rico's refusal to file a test case). COFINA's bondholders minimized the legal conflict and many loaded the boat, relying on a politically based validation letter from the Governor's appointed Secretary of Justice rather than Supreme Court validation. The more bonds that were issued, the more comfort investors had that the legal underpinnings of the COFINA structure would ever be called into question.

As the island's fiscal situation careened toward insolvency and default, and now receivership, the stage was gradually set for an inevitable showdown between COFINA buyers and GO bondholders. In June, GO bondholders sued the government to retain (or "clawback") COFINA sales tax revenues to pay its GO debt, citing their explicit Constitutional protection. The claim entitled Lex Claims LLC et al. v. García-Padilla contends that the SUV is an "available resource" under the Puerto Rico Constitution and seeks to strip COFINA creditors of their assumed property interests.

CSG's view: In coming months, the Lex Claims case will ultimately, we believe, invalidate the COFINA bond structure. The GO plaintiffs' succinct argument reflect an unassailable position: the COFINA structure reflects "complete disregard for the statutory and constitutional framework."

Beyond the Lex Claims strong legal arguments, one cannot ignore practical realities driving the case. Puerto Rico's Supreme Court Justices — citizens, parents, and grandparents — will now be presented with a case that asks them to weigh the legal merits as well as their the broader consequences. Their decision will determine whether generations of Puerto Ricans will pay a tax to repay debts that built no infrastructure or tangible assets, diverting precious resources off the island for generations.

For these reasons, CSG believes the Lex Claims case will result in an outcome where GO bondholders will realize hugely positive results and equally negative consequences for the COFINA debt holders. Next week, CSG will look more deeply into the broader consequences of this landmark decision.

PUERTO RICO REMAINS ON THE BRINK

Meanwhile, as part of an effort to restructure nearly $70 billion in public debt, **Puerto Rico's government has released a liquidity report saying the island will run out of money in less than three months.** Outgoing Governor Alejandro Garcia Padilla has been urging the board to authorize a debt restructuring and the report came just two days before a federal control board charged with overseeing the island's finances meets in Puerto Rico for the first time.

Looking ahead, Puerto Rico has a $1.3 billion debt payment in February, when a temporary debt moratorium expires. Another $934 million in bond payments is due from March through June. Finally, the pension system, which is underfunded by more than $40 billion, will run out of cash in 2018 unless the government takes steps such as increasing contributions.

The liquidity report was released on the same day that Ricky Rossello, Puerto Rico's governor-elect, met with bondholders and credit rating agencies in New York. Puerto Rico bonds have rallied since Rossello advanced his opinion that GO bonds are payable, at least partially. CSG reminds readers that Rossello, a political novice, is the son of the same Governor (Dr. Pedro Rossello, from 1993-2001) who began in earnest the island's current plight: its addiction to debt, the phaseout of Section 936, which had propped up the island's economy for decades, and its ill-fated quest for statehood (and Senate seat for Dr. Rossello).

MCDC: DISCLOSURE TROUBLES ISSUERS, BANKERS, INVESTORS

The fate of the SEC's Municipalities Continuing Disclosure Cooperation Initiative (MCDC) hangs in the balance as the municipal market anticipates the details of Trump's plans to roll back financial market regulations. Intended to address widespread violations of the federal securities laws in bond offering documents, MCDC has long been a scourge to underwriters and issuers who resent MCDC's high implementation costs, scoff at its intended benefit, and, fearing direct regulation, cling to the protection of the Tower Amendment. To date, more than 70 municipal underwriting firms and a similar number of issuers were cited for "misstatements and omissions" in their continuing disclosure statements.

Stoking fears of MCDCs' detractors, outgoing SEC chair Mary Jo White said recently the MCDC has been "enormously effective" uncovering numerous violations and implied that SEC needs direct regulatory authority over issuers. Her view is wistful: Trump soon will have a profound, sweeping impact on the Commission's direction and financial reform when he names a new SEC chairman and two of four commissioners.

CSG's view: The potential for a rollback of MCDC is a distressing picture for municipal investors. Just this year, we have seen a race to the bottom for disclosure practices, with Puerto Rico, Illinois, Miami, and Ramapo (NY) all competing to see who can bypass MCDC's disclosure practices. The small issuers continue to demand access to public markets without adequate information and large issuers continue to argue over whether all categories of their debt (direct bank loans) must be disclosed.

In a market that has seen its share of high-profile, distressed credits and inconsistent post-issuance disclosure, participants must give to broad consensus on best practices in this area. Instead, we see a legal-driven scramble to divide up responsibility among a significant number of investment bankers, advisers, issuers, government officials, all pointing at each other in circular standoff.

The result is an extended process of debate and implementation which has yet to yield anything close to a final result and leaves the investor at the mercy of these competing interests. In the meantime, the market continues to effectively let issuers skate as they continue to successfully issue debt despite questionable disclosure and continued bad financial practices.

ATLANTIC CITY FOLDS

With a $100 million annual budget deficit, a plummeting tax base (down from $20 billion in 2010 to $6 billion today reflecting five shuttered casinos) and $500 million in total debt, Atlantic City has fought the state since January to maintain local control.

This week, the fight finally ended, the culmination of a long-orchestrated process begun by Governor Chris Christie. Jeffrey Chiesa, a former state attorney general, U.S. senator and close ally of Christie, will be the man to lead the Atlantic City state takeover with vast powers to fix the city's dire finances. The city's mayor, Don Guardian, and City Council will maintain "day-to-day municipal functions" while Chiesa and state officials will implement fiscal-recovery efforts. Chiesa's authority includes the powers to sell city assets, hire or fire workers and break union contracts, among other powers, for up to five years.

Chiesa said in a statement, "I will…work hand-in-hand with local stakeholders to create solutions that will prevent waste and relieve generations of taxpayers from the burden of long-term debt. We will put Atlantic City back on a path to fiscal stability."

CSG view: We would have been disappointed if anything else had occurred. It would have been naive to expect a collaborative process to work. The populace and the political establishment had their chance and the city must now move forward.

PENSIONS, BANKRUPTCY & THE TRANSITION OF POWER

State and local pension funding will be a focal point in the coming years (months?) as the transition of power goes to the Trump Administration.

Case in point: Rep. Devin Nunes (R-CA) has long been an advocate to reign in pension problems at the state and local level. And, he's just been appointed to the executive committee of President-elect Donald Trump's transition team. Recall that Nunes, with a few high-profile co-sponsors (i.e. House Speaker Paul Ryan) has brought into light that state and local government pension woes are not going to be forgotten at the federal level. Nunes reintroduced a bill earlier this year that would bar state and local governments from issuing tax-exempt debt unless they filed annual pension plan reports with the Treasury Department. This is a bill that he has introduced with Ryan and Rep. Darrel Issa (R-CA) in the past, multiple times (April 2013 and February 2011).

A lot of this focus stemmed from state and local government economic woes following the financial crisis. Headlines were rampant, we had Meredith Whitney claiming there would be billions of defaults and it was an uneasy time, generally. Also recall the same time a few years ago when some in Congress decided to introduce legislation that would allow states be able to file for Chapter 9 bankruptcy. The response from Governors and state and local government associations was rapid to say, "No." It made ripples across the industry though, and headline risk moves this market.

As the transition of power changes hands in 2017, keep in mind these undercurrents. Municipal finance, markets, state and local governments, it seems, will get more attention than we perhaps thought a few weeks ago.

A number of states are or have been coming to market, which means that relatively fresh data (as much as that means in the land of municipals) on pension funding has been available. So we take this opportunity to review that data.

ILLINOIS — We start with the fact that pension bond debt service currently at $574 million and steadily increases annually to a 2033 level of $1.156 billion. In addition, the State issued pension bonds in 2010 and 2011. The use of pension bonds allowed the State to significantly reduce current contributions to the funds. However, the State continued to make less than the actuarially required contribution in each of the last 10 years. As the result of inadequate payments and below assumption investment returns, the State estimates that its unfunded pension liability increased in fiscal 2016 from $111 billion to $129 billion. That results in a funding ratio of 37% down from 41%.

WEST VIRGINIA — Data is through FY 2015. It has paid 100% of its ARC for its Public Employee and Teacher Pension Funds in each of the last two fiscal years. Its contributions as a percentage of employee payroll are 14% and 2% respectively. The State reports the Public Employees Fund to be 93% funded while the Teachers Fund is only 65% funded. The State is still using a 7.5% assumed investment return to determine its unfunded liability.

NEW HAMPSHIRE — The Granite State enacted a series of reforms in 2012. These included increases in the retirement ages for teachers (60 to 65) and police and fire (45 with 20 years service to 50 with 25 years service). It has met 100% of its ARC requirements since fiscal 2010. The State also reduced

its investment return assumption from 7.75% to 7.25%. The funding ratio however is a low 59%. That is a decrease from 67% over eight years.

MISSISSIPPI — The State still uses a generous 7.75% assumed rate of return on investment. The funding ratio is at 60% for the primary public employee fund. This despite steady increases in the employer contribution rate and a 2011 increase in the employee contribution rate. The goal is for the State to reach a funding level of 90% by 2042. For the public safety employee fund, the funding ratio is lower at 58%. Ironically, the State legislators fund has the best funding ratio at 78%.

COLORADO MOVES TO TEST MILEAGE FEES

As the focus on infrastructure financing gets more attention, we look to Colorado, the apparent thought-leader in innovative ways to raise funds (i.e. one of the first to legalize marijuana?). The Colorado Department of Transportation, which announced a new pilot study Thursday that will look into idea of replacing the state's gas tax with a pay-by-mile charge. It's called the Colorado's Road Usage Charge Pilot Research Study. The four-month study will launch in December, and will look at an approach where drivers would pay a fee for how many miles are traveled per month instead of paying the state's 22-cent per gallon gas tax at the pump.

By the year 2040, Colorado's population is expected to nearly double to 7.8 million residents, which will result in higher demands for mobility and on the state's transportation infrastructure, according to CDOT. "We are facing a nearly one billion dollar annual funding gap over the next 25 years," said CDOT. "And over the past two decades, Colorado's current gas tax has become less reliable with the spike in more fuel efficient vehicles and hybrids."

The department said the pilot is just the first step in an extensive process of evaluating the concept alongside other funding alternatives.

Some of the research topics in this study include mileage reporting technologies as well as a manual reporting option; how these technologies work in Colorado's environment and the difference in driving habits between urban and rural drivers.

The pilot study will begin in December and will end in spring 2017.