

MMA WEEKLY MUNICAST

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Interviewees: Tom Doe, Founder and CEO
of Municipal Market Advisors

Interviewer: Jim Towne, Senior Vice President at DerivActiv, LLC

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Episode Transcript:

Jim – Welcome Tom, nice to have you on the call today.

Tom – Hey Jim, always a pleasure.

Jim – Municipal yields peaked along with Treasuries in the first week of April and rallied in the month end. What was notable about the municipal markets movement last month?

Tom – The negative trend that emerged in March continued into the start of April. We saw yields peak about April 7th, government yields peaked on April 5, actually when the Treasury 10-year went above 4% for the first time in a long time, and municipal investors got kind of excited. We had a couple of large deals, Puerto Rico and Illinois, most notably doing tax-exempt and BAB financings all around that time kind of put upward pressure on the yields. And tax time is always a distraction for the individual investor. And once we got through April 15th we saw a resurgence of interest, we saw positive trend emerge. We saw new deals do pretty well, repricings to lower yields, we saw a couple [refundings] that were upsized and that was all very positive. And that created some good momentum ending the month. I guess kind of the crowning point month end on April 29th was a very aggressive pricing of the Wake County, North Carolina “AAA” name whose 10-year yield was priced under 3%. Those deals are always interesting to see when they occur at month end because it usually helps with price discovery and mark-to-market. Citigroup underwrote that deal, as a matter of fact, and they’ve always been prominent helping with price discovery in the market. And that became some very good momentum coming into May and here we are on May 7th and municipals have held pretty steady. A little bit of price resistance probably emerging now. We’ve seen secondary activity slow down a little bit. I think individuals with the recent volatility in the equity markets and all are a little distracted, which isn’t overly surprising. And we’ll kind of see where all this deflationary talk and stuff goes. But a good month for municipals in general, long end seemed to have some pretty good performance. The front end still seemed to be lagging a little bit, meaning between two and six years and investors probably can still find some value in that part of the curve.

Jim – BABs continue to be a major focus of municipal participants. What were the latest on pricing issuance and the effort to have the program extended?

Tom – BABs had a pretty interesting month in terms of discussion. One is the deals continue to be priced aggressively that with the subsidy allowed issuers to gain a great deal of savings. Of course the investors in BABs continue to be rewarded with higher yields than comparable corporate and sovereign credits. The dealers are liking to sell these “cheap bonds” so everybody still continues to be enthusiastic about the program. The probes and the questions by the IRS regarding the premium pricing of BABs and how Build America Bonds are trading in the secondary market, and the issue that was raised by Florida about the offsets, meaning that if there’s any type of dispute regarding state payments to the Federal government that the Federal government could withhold the subsidy or postpone it or create some disruption. The lack of clarity around some of those issues has, I think, created some pause among the issuer community. I think we saw that manifest in April in that the BAB issuance is only \$6.3 billion, the lowest since last July. Again April is usually kind of a lighter month in terms of municipal issuance in general. But this was particularly light and probably because of some of the issuance in Washington. The SIFMA held a conference on April 15th to discuss specifically the Build America Bond Pro-

grams and had representatives from Treasury and from the Senate and from issuers and then had a panel with investors and dealers. And I think what was most notable about that is that while everybody would like to see the program extended, and for various reasons of broadening the investor base, the big question that continues to loom over the market is, "What will that subsidy be for an extended program?" All the participants would like to have it be more, to have a higher number, 35% or comparable, and I think what everyone's struggling with in DC is trying to understand—where can the program pay for itself? Everyone talks about the savings in Build America Bonds, there's also the bonds that have been issued to date, which is about \$97-98 billion, will have a cost to the federal government of about \$52 billion in terms of subsidy payments. So you might project that we might hit the \$100 billion in terms of federal costs of the program over the life of the bonds that have been issued sometime late fourth quarter, and those become important benchmarks. I think the other thing that was interesting that was said during the conference by one of the major dealers was that BABs are attractive to investors because of the 70 to 100 basis point higher yield that's offered than say sovereigns or corporates. If you see that spread narrowing and coming into where it "should" trade and then back out of subsidy, this one dealer made the comment that the subsidy rate would about 25, 26% and the air just kind of went out of the room when that was mentioned because that would reduce the easy attractiveness of the program. So there's a lot of wood to chop still in terms of the discussion around BABs and I think the government's hoping to have something resolved by Memorial Day, but it's only three weeks away now.

Jim – Tom, May has been an extraordinary month already based on the flight-to-quality rally in Treasuries. What can we expect this month in the municipal sector?

Tom – Historically May is a pretty decent month, largely because dealers start to harvest the June 1 reinvestment, the coupon payments, the maturing bonds, they start to identify where that money is going to be available and they start putting it to work in May so that any type of issuance increase that may be experienced is easily absorbed and distributed. We always look back at what's happened since 1990, nearly over the last 30 years, and only six times have municipals during the month of May showed a price loss. And here we are the first week in May and it's clearly a positive month. Interesting to note that May hasn't produced a 1% price gain since 2003 so that will be the objective to see if it can do that. Back in the 1990s when we had similar to today traditional investor base, a 1% gain in May was much more common. So we're looking fairly positively to the month of May. Interest rates are pretty low and the absolute levels are impeding some investor interest as I mentioned a moment ago, but clearly the problems that are going on in the EU and the flight-to-quality are making municipals look a little bit more attractive, so I think this will kind of keep investor interest. We think May will be pretty good.

Jim – Yesterday the short seller, Jim Chanos, was again in the press regarding the risks in the municipal market. Seems each month there's someone talking down the muni market. What are your latest thoughts on the risks for investors?

Tom – Well Jim Chanos, we've talked about him before and he's, I would say, a notorious short-seller. He's made his money on destroying markets and making money on the short side. And somehow he's focusing on these pension issues that face many states around the country and came out in November of last year in *Barron's* would seem to be kind of a well-placed comment to scare municipal investors to unload their strong investment grade credits on fanning flames of threats to GO debt. And of course with fewer tax-exempt bonds because of the Build America Bonds and fewer investment grade, especially long maturing bonds, that's great strategy to try to loosen those up to buy them, that's the cynic in me. He was again on CNBC yesterday talking about the same thing except this was really interesting, is he made the comment that if states had any kind of fiscal problems and the federal government came in, that the federal government would look at municipal bond holders with disdain because they're wealthy. And three times he characterized muni investors as those "bad, wealthy people." Really I think, an irresponsible way, especially in that type of media format, to scare investors. We published a report on January 25th that we're glad to make available to investors. They can simply contact us through our website and we're glad to give our view as to what we think are the real risks, which we think are very low relative to the state pension issue. Just yesterday this issue was addressed, this time by a woman at the Manhattan Institute and she again kind of made similar type of comments. We think that they're fairly ill-founded and not well researched and understood regarding the municipal market. So these become very popular items. Municipal investors are certainly reading these pieces and are becoming fearful. I think it has impacted some of the weaker credits in the market. But as we track credit impairment notices, where the problems are in the muni market, and certainly these fiscal stresses are manifesting in terms of weakened performance or default risk, but again only \$20 billion of these nearly \$3 trillion market are in default. Nearly half the loans that are having credit impairment notices are land secured deals, some would call them land speculative deals. A lot are unrated securities. They're in risky sec-

tors that most individual investors are not involved in, they're really securities, and where the risks, they're being handled by professional investors. So I think these concerns that are in the headlines right now are overstated, and we think—irresponsible.

Jim – As we think about credit risks, was there much activity in credit spreads in April?

Tom – Just what we were talking about, here are all these issues about muni credit, in fact we didn't see muni spreads widen really much at all. There was a little bit of credit widening but it was mainly because of the high-grade performance from these smaller \$100 million super "AAA" names like Wake County that really put spread in the market. But the high-yield sector was relative quiet and even California, was the subject of so much attention and concern regarding the state pension issues and all this have performed extraordinarily well. In fact April, if we look at ETFs, California ETFs became the top performing sector year-to-date, outperforming high-yield or at least matching high-yield performance which continues to be the leading area. Investors want yield, the people that are in those weaker credits, excluding those that we've just mentioned earlier, are seeing pretty good returns. They're looking to drop down the ratings curve.

Jim – Were you aware of much impact from Moody's and Fitch's implementation of the recalibrated municipal rating scales?

Tom – The recalibration of both Moody's and Fitch were implemented in April. We didn't see any noticeable affect yet. I think though going forward we'll see it harder to discern performance attributes of individual credits. I think there'll be a homogenization that will occur in the municipal market and I think we saw in April a little bit of confusion about just what does it all mean and so as a result we didn't see any individual names or get a particular boost, really aside from California.

Jim – Finally Tom, we talked a little about issuance earlier regarding BABs, do you care to look into your crystal ball about issuance and demand for the balance of the year?

Tom – I think what we're going to see Jim, is it looks like we're on a pace to see tax-exempt issuance just a little bit more than \$300 billion for the year, maybe it's about \$325. That industry annual total takes us back to 2002 and that is a pretty good number. Again that was prior to when we really had the leverage investor dominant in the muni market. And I think that's a number that can be real balance for the municipal industry, meaning there's enough institutional demand, there's enough retail demand that allows issuers access. The BAB component again could be on track to be about \$100 billion this year, unless we see some changes in Congress or the program is not extended with a high enough subsidy to lure investor interest, then we might see this thing not have as much Build America Bond interest as we had anticipated. My guess is tax-exempt issuance will be between \$300 and \$350 billion, that probably is very digestible. We aren't going to see any real big credit flare-ups in the investment grade space. We may see some kind of high-yield thing that gets some attention, but I think that's probably where we are and probably a decent year ahead. That can be kind of a negative thing for a lot of people, and again what we're seeing overseas, but I think we're seeing some good movement in terms of some strong politicians, of what we're seeing in New Jersey for example, seeing state revenues increase a little bit as well. So things will slowly get better, but I think stability and reasonable issuance will be the theme.

Jim – Thanks Tom, we look forward to speaking with you again next month.

Tom – Sounds great Jim. Take care.

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