Municipal Rundown 10/30/15

Illinois vs. Other

Last week Illinois was downgraded to Baa1 by Moody's and BBB+ by Fitch. Not surprising given the budget stalemate that endures and the lack of foreseeable progress or compromise. The good news is that the state constitution includes legal provisions that ensure payment of debts even without the enactment of a budget. Standard & Poor's noted that the lack of state budget has not impacted local government ratings, as most local governments have reserves and ample liquidity at this point.

The not-so-good news is that since 2011 Illinois' unfunded accrued state employee pension liability has grown from \$82 billion to \$111 billion. The funded ratio has thus declined from 43.4% to 39.3%. Last spring's Illinois State Supreme Court reversal of a 2013 public employee retirement benefits overhaul didn't help. Moody's comments that the "weakening of the state's financial position during 2015 and the expectation of an ongoing stalemate will lead to further deterioration". Doesn't sound promising! Riverbend Capital has avoided State of Illinois GO's in client accounts since the inception of our firm, as we've found ample opportunity elsewhere in the market.

Around the country outside of Illinois, things are generally looking up from a budgetary perspective. Tax collections have been solid and spending has been restrained. There are exceptions like Pennsylvania and New Jersey, but the fiscal situations of most states and municipalities are sound. According to Bloomberg, more than two thirds of US state pension funds experienced significant improvement in 2014. The median gain was 16.9% and the average state level of funding is now 70%. Returns on equity investments certainly helped. Illinois level of 39.3% (as previously noted) is the worst.

Year-Over-Year Percent Change

Quarter	Personal Income Tax	Corporate Income Tax	General Sales Tax	Motor Fuel Sales Tax	TOTAL TAXES
2015 Q1	7.1	3.3	5.2	4.4	5.8
2014 Q1	(0.6)	8.3	1.9	2.8	0.3
2013 Q1	18.1	9.4	5.6	(1.4)	9.8
2012 Q1	4.3	4.0	5.0	1.0	3.9
2011 Q1	12.4	3.7	6.4	13.3	10.1
2010 Q1	3.8	0.3	0.1	(0.1)	3.4
2009 Q1	(19.2)	(20.2)	(8.4)	(3.6)	(12.2)
2008 Q1	5.6	(1.4)	0.7	1.1	2.9

Source: Rockefeller Institute of Government

Puerto Rico: The Beat Goes On…

There’s a new twist almost every day in this story, but most recently the Obama administration asked Congress to grant Puerto Rico the ability to seek bankruptcy protection in order to shed some of its $72 billion in debt obligations. The proposal would enable the struggling territory to seek a financial restructuring under federal court supervision, an option not currently available. The administration is also requesting oversight of Puerto Rico’s finances. This occurred after efforts to reach a consensual restructuring of debts between the Puerto Rico Government Development Bank and a group of investors failed to produce an agreement. The situation seems more likely to play out in court than to be negotiated.

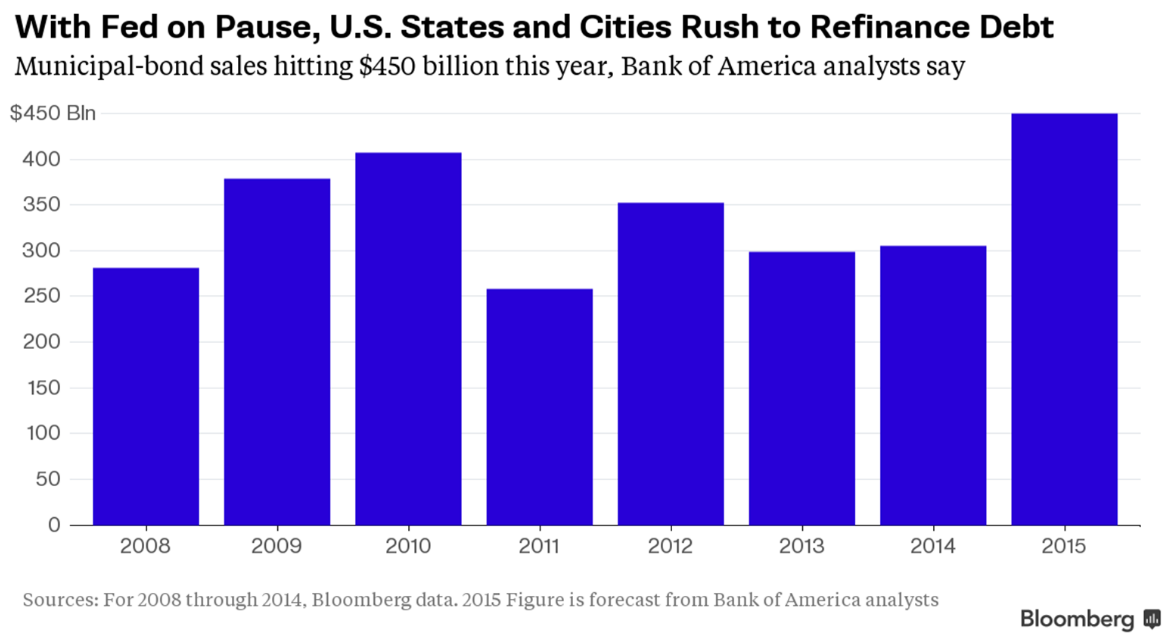
Puerto Rico government officials have stated that the Commonwealth will run out of operating funds by November, pushing it to the point of default on major debt payments. The projection is of a negative $30 million cash balance in November with $355 in GDB debt service payments due on December 1st. Puerto Rico Governor Alejandro Padilla told Congress last week that his government will soon need to choose between “paying its creditors and providing essential services to the island’s 3.5 million American citizens”.

While Puerto Rico’s inability to repay its substantial debt may not directly affect municipal bond investors who do not own individual PR bonds, it could impact muni mutual fund investors who may be unaware of their fund’s exposure. In 2013 Morningstar, a Chicago investment research firm, estimated that 180 mutual funds in the U.S. and elsewhere have more than 5% of their portfolios in PR bonds. Direct ownership of individual bonds in a separate account can provide a helpful degree of transparency.

Supply, Demand, Performance and Flows

Year to date municipal bond new issuance exceeds $320 billion, the most since 2003. We expect the total for 2015 to be well in excess of $400 billion. Much of this year’s supply (approximately two thirds) has been refunding, as states and cities take advantage of lower rates. For the first time in five years, the par amount of outstanding munis will grow. We had experienced small, incremental contraction in the size of the market since 2009.

Municipalities remain reluctant to add to debt burdens despite the growing need for infrastructure improvements. This has been the case consistently since the 2008 financial crisis. At some point addressing public works issues like sewer systems, bridges and mass transit lines will become more difficult to postpone.



Traditionally the 4th quarter is a time of heavy supply as municipalities rush to issue bonds before year end. Even if this is the case over the next couple of months, it's unlikely to weigh on market performance. Demand remains strong. New issues are well-received and usually oversubscribed. Funds have seen inflows of more than $5 billion in 2015. There seems to be plenty of cash on the sidelines as well. Munis continue to look attractive on an after-tax basis.

The muni market has performed decently in 2015, with the BofA Merrill Lynch Broad Market Muni Master Index up 2.1%, vs 2% for UST and .7% for corporate bonds. Intermediate and long yields have stayed in an eight basis point band for all of October. The 10-15 year range now captures more than 75% of maximum yield, and the curve flattens beyond 20 years. Not much incentive to reach for yield by extending duration.

Kicker Appeal

We've been longtime proponents of premium callable "kicker" bonds due to their defensive nature and attractive yield to call / maturity characteristics vs non-callable bullets. Of late this structure has grown more appealing and has actually received attention in financial media.

Fortunately there's often confusion with regard to valuing these structures and opportunities are still present, as is the ongoing need to remain selective.

Please

Feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

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