

MMA WEEKLY MUNICAST

February 8, 2010

Interviewees: Tom Doe, Founder and CEO and
Matt Fabian, Managing Director and Lead Analyst at Municipal Market Advisors

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

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Episode Transcript:

Jim – Welcome to this week's episode of MMA MuniCast. I'm your host Jim Towne. I'd like to welcome Tom Doe to today's podcast. Tom is founder and CEO of Municipal Market Advisors. Also joining us today is Matt Fabian Managing Director at Municipal Market Advisors and its lead analyst. Welcome guys.

Tom – Nice to talk to you again Jim.

Jim – Nice to have both of you with us today.

Tom – It's a pleasure.

Jim – Before we discuss the Build America Bond extension possibilities Tom, can you sum up the activity of January?

Tom – Well you know it was a surprisingly quiet month that had a couple different characteristics. A little bit firm at the start with the large reinvestment flows that are typical of the month of January and then as the month proceeded it started to lose a little of its strength and by the end of the month the municipal market was much more tenuous and a lot of that is just the absolute yields remain pretty low, the ratios between municipals and Treasuries or munis and LIBOR were lower than the historical averages, and so a lot of the large institutional players were on the sideline or were cautiously investing cash. We certainly saw investment flows into the mutual funds continue. That has been a theme for the last year and a half and helped to move inventory. But we did see somewhat higher dealer inventories at the end of the month that again, perhaps a little caution, I think a lot of people were looking at the calendar and getting a little bit nervous, but I think overall the market was relatively placid, price volatility was extraordinarily low, credit issues emerged as they have, but for the month it was all relatively calm.

Jim – And let me follow-up to ask you to explain your reference to the negative seasonals that you wrote about in the recent January Advisor.

Tom – What has happened actually over the last 100 years of the municipal market is that the period between February 15th and April 15th there is a negative price bias. And it's well remembered by many of the market participants and even last year between February 15th and March 15th there was about a 33 basis point rise in the 10-year high-grade maturity. So a lot of people remember that this is kind of an adverse time of year. And why is that? Well it's because you have less municipal reinvestment flows from coupon payments in February and in March. You also have a resurgence of municipal issuance and you have, very simply, a supply demand imbalance. What is of particular concern during this period now is that now that the municipal market depends on the traditional investor for that demand is that when we look at those periods of time in the market's history and most notably between 1995 and 1999, the market was particularly vulnerable when that supply-demand imbalance occurred. This year it can always be different. Certainly the introduction of the Build America Bond Program and how that reduces tax-exempt supply could be a big factor in reducing supply and making it a bit more of a balance this year so that could be a positive. But we are at much lower yields than we were a

year ago, the ratios again are much lower so crossover accounts maybe less active, and today as we were talking before we started this recording, we're seeing the Treasury market, anyway, sore ahead of tomorrow's non-farm payroll numbers and of course the auctions. So it is not uncharacteristic to see the first two weeks of February be firm, but the whole market is being very wary of that February through mid April period.

Jim – Okay Matt, it's BAB time. What is the latest? Any sense of the response to the Obama Administration's proposal?

Matt– I think overall it's been fairly supportive. I think that most accounts believe that a permanent extension of the BAB program will greatly increase demand because then there is less fear of curve buyers being stuck with something that's become a market orphan with lower liquidity, so there is a sense that the program will get made into a permanent thing. It is still a long process and we've only just begun the budget debates. The BAB language could be included into the discussion of the jobs bill which could come sooner, but regardless there is just tremendous political support in Congress and the administration and then on the lobby side for the BAB program. So some kind of very long-term extension possibly permanent will likely occur. Prospects for issuance then this year will probably only increase because there's the expectation of better demand knowing that it's a more permanent program overall. That is assuming of course that relative value in munis remains about where it is. If tax-exempt bonds continue to be priced so strongly and have such success in keeping yields low and if Treasury yields rise, of course they've been falling today, but if Treasury yields continue to rise then there may be less presence in BABs because they may not make as much sense for issuers who are going to be looking at whichever is the best execution for them at that particular time.

Jim – To return to the market, municipal issuance as measured by the 30-day calendar is extremely low, even for this time of year. Is there anything to read into this?

Tom – Well I think that number yesterday looked like that 30-day supply number was less than \$6 billion and to give you kind of idea of comparison, last year it was around \$10 billion at this time of year. Again, we'll probably be looking at February issuance, tax-exempt issuance, probably being around \$20 billion and Build America Bond component is probably going to be somewhere between \$5 and \$10 billion for the month. I think what is interesting and we're reading into this, is that perhaps what's out on the calendar right now is a little bit lower because so many municipal issuers are contemplating pursuing the Build America Bond avenue. Certainly the subsidy, which is so attractive to the issuer, is prompting them to consider it and certainly they should, why not? And I think that there is some real thought about that and that may be putting a little bit less on the calendar. We are informed from some of the major dealer firms that after mid-month the calendar will swell significantly, so that would be right on schedule. I think it's a little bit more reflective that there's a lot more for issuers to consider right now. They're trying to be creative. They're also trying to battle these budget headlines as we saw yesterday with New York MTA's downgrade and how it interrupted the pricing process, and some of the headlines around New Jersey, and of course California remains ever present. These are things that I think are inhibiting issuer activity and the primary market being a little bit slower. There's a lot to consider for issuers right now.

Matt– Just like Tom said, I think it's going to be a temporary issue. You know long term the administration and Congress are trying to encourage job creation through infrastructure construction and that's funded through debt. So there should be a very large amount of issuance coming out of the municipal sector this year, next year, probably over the next five years. Any kind of respite now would be just a temporary one.

Tom – And to Matt's point, I think one of the interesting risks again, as we were just talking about how today is a complete turnaround to yesterday, at least in the Treasury market. And if there is a surge and investors starting to feel a need to grab a scarcity in tax-exempt product, right here ahead of what seems to be a very light calendar, the uniformed participant could really end up buying bonds at a premium price that could severely under-perform and first quarter performance could be negatively impacted, so for us, from our seat as being observers of the market and strategists, you can't get any higher drama than this when these kind of events unfold.

Jim – Matt you've been analyzing the credit impairment notices in the MMA's Weekly Outlook. What is the latest and can you sum up what has occurred since you began tracking the events last year?

Matt— You know there have been a continuing, you wouldn't say a flood, it's been probably slowing down a little bit recently, but we're still getting about say around twenty new notices every week, which are notices of issuers in some kind of financial distress or notifying of ongoing issues. We've talked about this before on the podcast, you know the credit issues that are coming up are almost exactly where you would expect them to be, real estate based transactions like apartments, and land speculation districts, and hotels, largely with non-rated financing. Lower rated things that were probably mostly purchased by high yield mutual funds with sort of the expectation of some default risk. They're have been very few things outside of Jefferson County among traditionally safe sectors. The only real payment default that we've seen in the safe sector area is the City of Menosha in Wisconsin, a \$10 million bond general obligation steam bond which is in payment default. Beyond that there are other issues out there like Harrisburg with its insured bonds, which are not necessarily being disclosed, where there is still issues for safe sector bonds. But in general there have been very, very few in that traditional muni safe area. It is reassuring in a sense, although you never know what tomorrow will hold, and there could reasonably be some increase in payment defaults among safe bonds.

Jim – Finally Matt, there was some recent changes regarding regulation in the money fund sector, 2A7 Funds. Can you explain? We certainly have noticed the large outflows over the past year and wasn't there a week in January when \$9 billion left the funds?

Matt— Since the post-Lehman collapse in money funds everywhere, there has been a real effort on the part of SEC and other regulators to come up with a plan to prevent similar runs. Unfortunately the proposals that have come up, the official proposals at any rate, probably would not have stopped what happened after Lehman. That was really a systemic problem. The proposals that have been advanced are really more at improving the money fund industry on a fund by fund basis. They should stop investors from fleeing a particular fund for having credit issues, although it's really not clear. I mean anything short of 100% reserves probably would not have prevented the damage that happened after Lehman. So the SEC had proposed rules that came out last summer. They took comments on them that ended in September and they just put through their official rules, they actually adopted rules, which look like they may go farther than we had expected. We haven't seen the actual rules yet because they haven't been put up on their website as of this time. It should be any day now that we'll be able to review them. The point though I think, is that the money funds will have to maintain larger cash balances, will be restricted to shorter maturity bonds and higher quality, higher rated bonds, so there will be fewer things for the money funds to buy, which will mean only more scarcity and lower floating rate yields in the near term, at least in tax-exempts. So that sort of supports a very bullish view toward the front of the muni fixed-rate yield curve as lower floating rate yields will help keep short fixed-rate yields also low, as people speculate on money fund demands. It's good for the front of the muni yield curve, but will be a challenge for the tax-exempt money funds as they look for product and look to maximize the yield provided to their investors.