

Municipal Market Report

GAME CHANGING EVENTS: Elections, Federal Reserve, Regulation

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A few significant events are taking place in the coming days and weeks that could have immediate and long term impacts on the municipal market. The mid term elections, the Federal Reserve quantitative easing (QE2), new unemployment data, regulatory reform continued heavy taxable Build America Bond ("BAB") supply through mid December and increasingly burdensome dealer inventories. The BAB extension bill that has been put on hold until after the elections this week and a GOP victory in the House may even stall action on the extension bill into next year. The small-issuer exemption for bank qualified issues up to \$30 million (from \$10 million in years past), which has been very beneficial to not-for-profit institutions, is also set to expire at year end, unless Congress acts.

The lame-duck session will be unpredictable with Republican control of the House. The GOP may be less willing to compromise on important issues before assuming power in January. Representative Jeb Hensarling (R., Texas) states "it would be my hope that the Congress in a lame-duck session would only do the absolutely positively necessary business of the Republic, and otherwise wait for the new Congress to take on some incredibly weighty issues in January."

The Federal Reserve's QE2 has ramifications for all the bond markets in that the program should keep rates low for the foreseeable future. Though the impact, depending on the size and scope of the purchase program, has the potential to move treasury rates greater than municipal rates. Municipal rates will lag as the Fed purchases treasury securities and not municipal bonds. There is some built in expectation in the treasury market that the Fed will purchase \$500 billion or more securities reflected in a recent survey by Bloomberg.

Municipal Bond Supply

The new issue calendar has been and will continue to be laden with taxable BAB issues trying to get to market before year end to take advantage of the current 35% federal subsidy on eligible governmental projects. BABs have dominated the primary market and buyers have plenty of these bonds to choose from. New Jersey's Rutgers University is issuing bonds this week and Bruce Fehn, University Senior Vice President for Finance and Administration, states "we're afraid the program might not get extended so we want to get it done before the subsidy expires." Conversely traditional tax-exempt new issues remain relatively scarce. [The Bond Buyer](#) reports that many of these BAB issuers had traditionally sold tax-exempt debt, resulting in a reduction of tax-exempt volume to levels not seen since 2001. Also, this limited tax-exempt supply has kept long term tax-exempt rates close to their lows of late August and early September, as seen in the chart to the right. As it has become clear that the Fed will try to keep rates low well into next year, investors have built up more courage to extend out the yield curve to pick up yield.

Year to date issuance stands at \$340.5 billion, 1.6% higher than last year at this time, according to [The Bond Buyer](#). Last month, taxable BAB issuance was \$15.9 billion or 38% of new issue volume. Year to date taxable issuance increased 70% over last year, while tax-exempt issuance has shrunk 16%. These supply composition trends should continue into year end.

With all these market dynamics and uncertainties at play, it is important that issuers seek out counsel from financial advisors like BLX Group to help address topics such as program eligibility, structure options, covenants, timing, pricing, and compliance.

MMD AAA Spots & Slope

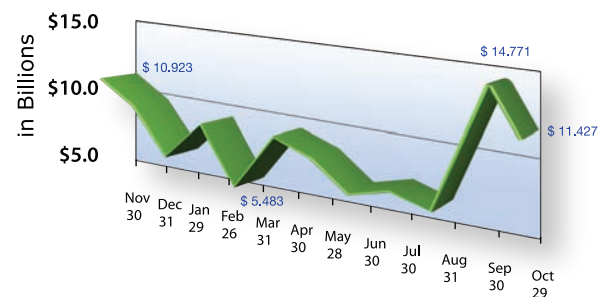
DATE	1-yr	5-yr	10-yr	15-yr	20-yr	25-yr	30-yr	Slope
7-1-2010	0.30	1.56	2.79	3.37	3.75	3.97	4.02	372
8-1-2010	0.25	1.30	2.58	3.21	3.67	3.92	3.97	372
9-1-2010	0.25	1.07	2.19	2.77	3.29	3.62	3.68	343
10-1-2010	0.30	1.21	2.43	2.91	3.32	3.64	3.72	342
11-1-2010	0.30	1.20	2.51	3.08	3.48	3.78	3.86	356

source: Thomson Reuters

30-Day Visible Supply

11/01/2009 - 11/01/2010 Monthly

source: Thomson Reuters



Bond Insurance News

Ambac Financial Group, of which Ambac Assurance Corp. is a subsidiary, may be forced to file bankruptcy by December 31, 2010 due to a continued inability to raise sufficient capital to satisfy regulatory requirements. This is not expected to have any impact on the trading value of municipal bonds insured by AMBAC as these securities have been priced based upon the underlying credit of the borrower since the insurer was downgraded to junk status.

The Municipal and Infrastructure Assurance Corporation (MIAC), which was issued expedited licenses by state regulators to provide municipal and infrastructure insurance, has decided to abandon the bond insurance sector. The insurer never received ratings from the major rating agencies and its sponsor, Macquarie Group is reviewing options to sell or wind down the entity. The failure of MIAC to provide another viable alternative to Assured Guaranty brings into question the long term relevance and viability of the municipal bond insurance business model.

Assured Guaranty was downgraded on October 26th by Standard and Poor's (S&P), losing its one triple A rating. The report cited concerns about capital adequacy and the struggling financial guarantee market as reasons for the downgrade. The insurer is now rated AA+ with a stable outlook by S & P and Aa3 with a negative outlook by Moody's Investors Service. Assured is the sole active insurer in the municipal market, capturing 100% of new issues wrapped in the first three quarters of 2010, but only 7% of the total market.

Municipal Market Regulation

The Securities and Exchange Commission (SEC) held its first of six scheduled field hearings on the municipal market in San Francisco in September. No dates have been scheduled as of yet for the five remaining meetings to be held in Chicago, Washington D.C., Tallahassee, Austin and Birmingham. At the first hearing, SEC Commissioner Elise Walters stressed her concerns regarding the lack of timely and accurate information flow to investors as illustrated by the following portion of her opening comments:

"Despite its size and obvious importance, the municipal securities market lacks many of the protections customary in many other sectors of the U.S. capital markets. Investors in municipal securities should have the same rights as investors in other types of securities to receive information that is not materially misleading and does not contain material omissions — that includes receiving financial and other material information that is not stale. These precepts are central to informed investment decision-making and investor protection. As I have previously bemoaned, investors in municipal securities are, in certain respects, afforded "second-class treatment" today. I, for one, believe that needs a hard look."

SEC Commissioner Elaine Greenberg's comments at the news conference announcing the SEC's new leaders in enforcement in January 2010 echoed similar sentiments as to the direction of new municipal market regulation. Ms. Greenberg is the Chief of the Municipal Securities and Public Pension Unit for the SEC. An excerpt from her comments as to the new unit's focus follows:

"This unit will focus its efforts on investigating and pursuing enforcement actions in five categories of misconduct: (1) offering and disclosure fraud; (2) tax or arbitrage driven fraud; (3) pay-to-play and public corruption violations; (4) public pension accounting and disclosure violations; and (5) valuation and pricing fraud."

In other regulatory matters, the Municipal Securities Rulemaking Board (MSRB) filed several proposed rule changes with the SEC on November 1, 2010 including extending certain "core MSRB rules of conduct to municipal advisors, as well as proposed rule changes that... will permit municipal advisors to begin registering with the MSRB." The expansion of the MSRB's role/mission pertaining to financial advisors and the resultant rule changes are a direct outcome of the Dodd-Frank Financial Reform Act.

On October 27, 2010 the SEC announced the resolution of a case against four City of San Diego officials which was originally filed in April 2008. The charges brought by the SEC alleged that "the officials knew that the city had been intentionally under-funding its pension obligations so that it could increase pension benefits but defer the costs." The officials agreed to pay financial penalties but have neither admitted nor denied the allegations.