Municipal

STRATEGYQUARTERLY

MARKET PERSPECTIVES – FIXED INCOME SERVICES

"There are risks and costs to action. But they are far less than the long-range risks of comfortable inaction." - *John F. Kennedy*

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The U.S. economy continues to see modest economic growth, solid job creation, and low oil prices helping to boost consumer spending all while inflation and wage growth remain frustratingly low. This mixed-bag of data leaves markets to ebb and flow with the latest news stories but has kept interest rates low in the first months of 2015. The multi-decade cycle of falling interest rates continues, with the general trend being one of *falling* interest rates across the yield curve: municipal AAA 10-year yields hover around 2.00%, a roughly 20% drop from one year ago. Harmoniously, the average 30-year municipal AAA yield is down over 25% from the levels seen just a year ago.

It's been more than seven years since the beginning of the Great Recession, Quantitative Easing is complete and the economy is picking up, yet, fixed income investors are faced with a challenging environment. Front-end yields remain low, longer-term yields are coming down, and supply in the municipal markets is limited. Although these challenges exist, municipal bonds will always have a place for those investors seeking a competitive after-tax return with limited volatility and very low historic default risks.

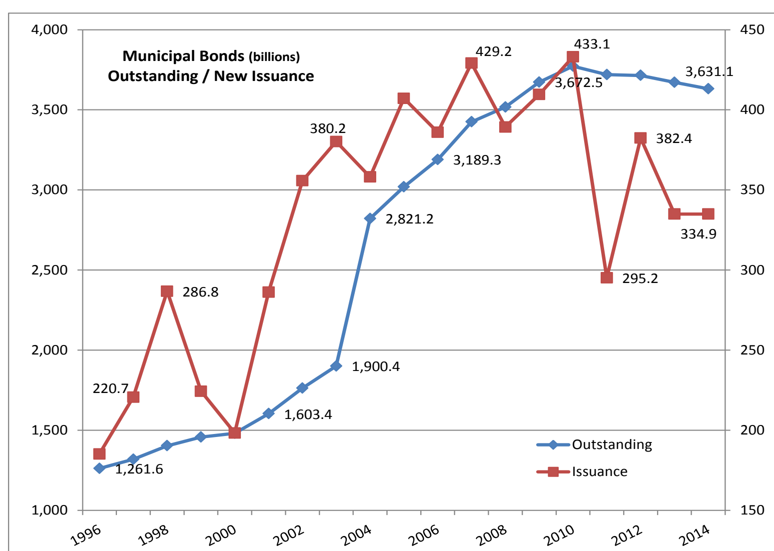
The following pages highlight the municipal expertise of Raymond James as both an underwriter in the primary market and as a dealer in the secondary market. It will discuss several hot topics within the municipal world including how General Obligation (GO) bonds have come under fire during the last five years as we have experienced several high profile government bankruptcies. Despite these headlines, GOs continue to be highly regarded as their strong credit quality is a result of their taxing ability and historical track record. Has perception or reality changed this view, or is this just more noise? Also, how have recent bankruptcies treated GO credits? On another topic, one way to combat the challenging markets is with "kicker" or "cushion" municipal bonds. We explain the benefits of this structure and why it should be considered. Also, many issues are hitting the news, some of which are addressed with just a word or two to get the reader up to speed. ▪

Rankings Matter

Raymond James is moving up the national municipal bond underwriting rankings, now 8th overall with over $12 billion par amount in 2014. The national rankings are based on the total par amount of the book run. The largest financial houses will run the books for extremely large deals, thus affecting the averages. For most retail investors (those not needing to put $100 million dollar positions in their accounts), these massive deals offer little to no benefit.

A more meaningful ranking for a retail investor may be the number of issues underwritten. This provides investors access to a more diversified basket of offerings and wider selection for a tailored portfolio. Raymond James' diversification and strong regional presence put it in a unique position to participate in a large number of issues. When viewed by number of issues, Raymond James ranks 2nd among all dealers. Raymond James ranks in the top 10 dollar amount and number of issues in the southeast, southwest, northeast and south central regions. Widespread coverage offers the benefits of new issues and perhaps more importantly, extensive and consistent product-flow throughout the nation.

The Takeaway: Why does this matter? The benefits of a large market presence both geographically and in volume/size offer Raymond James' clients the best of all worlds. Our municipal market presence creates a competitive advantage in the primary market but perhaps more importantly in the secondary market for investors proactive in the tax advantaged municipal market. As new issues shrink, the importance of market share and geographic diversification allow our clients to optimize their opportunities. ▪



Source: SIFMA data, Raymond James

National 2014 Rankings By Par Amount

Book Runner	Par Amt ($mil)	# Issues
Bank of America	43,969.6	377
J.P. Morgan	37,262.3	337
Citi	31,346.6	374
Morgan Stanley	27,814.0	294
Wells Fargo	21,905.3	230
RBC Capital	20,136.9	568
Barclays	13,927.3	96
Raymond James	12,771.3	600
Goldman Sachs	11,060.0	72
Stifel Nicolaus	10,882.2	72

source: Thomson Reuters

National 2014 Rankings By # Issues

Book Runner	Par Amt ($mil)	# Issues
Robert W Baird	8,010.9	790
Raymond James	12,771.3	600
RBC Capital	20,136.9	568
Stifel Nicolaus	10,882.2	552
Piper Jaffray	9,817.6	517
Bank of America	43,969.6	377
Citi	31,346.6	374
Roosevelt & Cross	2,204.7	373
J P Morgan	37,262.3	337
BOSC Inc	2,692.9	314

source: Thomson Reuters

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General Obligation (GO) Bonds

History has established general obligation (GO) Bonds as the benchmark credit for municipal bond debt. GOs have long been considered superior credit securities to revenue bonds because the pledge of specific revenues rarely matches the available sources and taxing power associated with funding GOs. Evidence has supported this credit superiority. Moody's reports that only 8 of the 80 defaults from 1970-2013 have been GOs. Recent history has given some investors pause as several large municipalities have filed for bankruptcy including: San Bernardino, Stockton, Jefferson County and Detroit. Jefferson County was the first large bankruptcy where GO creditors did not receive full payment.

Have these recent municipal defaults changed the way investors think about general obligation debt? History has exposed a concentration of municipal defaults in healthcare and local housing projects but recent events have raised questions about general government credits. Detroit became the largest U.S. municipal default with over $8.4 billion in debt. Detroit's attempt to repudiate its certificate of participation (COP) obligation and renegotiate other debt, continued widespread pension costs and instability, competing legal wars between pensioners and bondholders, and variability on post-bankruptcy recovery all contributed to questioning the essential general obligation value.

Even so, general obligations and their municipal credits have held strong. The one-year default rate averages 0.03% over the last 5 years and 0.01% since 1970 according to Moody's Investors Service. The average ultimate recovery rate for municipal bonds averaged 64%, although the range varies greatly from 0% to 100% among the various credits. Detroit, for example, appears as if unlimited GO holders will recover 74%, limited GOs 10%-13%, and COPs potentially nothing.

Many of the questions about recovery arise because municipal defaults are rare. Expectations for recovery are currently developing. Pensions and Other Post Employee Benefits (OPEBs) are sizeable issues associated with municipalities. Municipalities such as the city of Chicago and California's CalPERS system are facing these issues head-on with substantial risk to their funding costs over the next several years as a result of pension and OPEB shortfalls. Although none of this may be precedent setting, the nuances related to GO security features are becoming increasingly important in determining bondholder recovery in bankruptcy. This has prompted the National Association of Bond Lawyers to suggest additional bond document disclosures related to specific GO security provisions which may prove important in determining relative bondholder recovery amounts. ▪

GO Bankruptcy Treatment:

- Despite a full faith and credit GO pledge, bankruptcy courts cannot require municipalities to raise taxes or sell assets in order to pay creditors.
- Providing residents with essential services will likely be the top priority of the court.
- "Secured" claims have an elevated status.
- Bonds structured with a lien on specific revenue stream continue to receive those revenues.
- "Unsecured" claims have a reduced claim status.
- GO bonds with an additional revenue stream (double-barrel) are likely to be considered secured.
- States where GOs have a statutory lien: California, Colorado, Louisiana, Utah and Rhode Island. Other states may treat GOs as unsecured debt.

Largest Oil Producing States

	----Reserves----- billion BarrelOil	CuFt (tri) NatGas
LA	0.463	22.1
UT	0.613	7.8
CO	0.618	21.7
WY	0.706	N/A
OK	0.934	28.7
NM	0.965	14.6
CA	3.0	2.1
AK	3.3	9.7
ND	3.8	4.0
TX	9.6	93.5

Source: 24/7 Wall St

Don't Collect Revenue Taxes:

Delaware	Georgia
Hawaii	Illinois
Iowa	Maine
Maryland	Massachusetts
New Hampshire	New Jersey
New York	Pennsylvania
Rhode Island	South Carolina
Vermont	

Collect <1% Revenue Taxes:

Arizona	Arkansas
California	Connecticut
Florida	Idaho
Indiana	Kansas
Michigan	Minnesota
Missouri	Nebraska
North Carolina	Ohio
Oregon	South Dakota
Tennessee	Virginia
Washington	Wisconsin

Ranked Reliance on Revenue Taxes ([1]=greatest reliance):

Alaska[1]	North Dakota[2]
Wyoming[3]	New Mexico[4]
West Virginia[5]	Montana[6]
Louisiana[7]	Texas[7]
Oklahoma[9]	Kentucky[11]
Utah[12]	Mississippi[13]
Alabama[14]	Colorado[14]

Source: U.S. Census Bureau, 2013 Annual Survey of State Government Tax Collections

Will Oil Prices Impact Municipalities?

Oil has seen its share of volatility beginning 2014 at $95.44/barrel, peaking at $107.26/barrel, and ending 2014 at $53.27/barrel. In January, 2015 it hit a low of $44.45 and as of February 17, 2015, it sits at $51.53/barrel. The top ten oil producing states are listed in the left hand column where the state of Texas accounts for over 1/3 of U.S. production. If Texas were its own country, it would be the 6th largest oil producer in the world according to 24/7 Wall St.

Will oil have an impact on municipalities, their stability, and thus the credit-worthiness of their debt? It is likely that states with the most reliance on oil production tax revenues will be impacted most by dramatic oil price moves. It is questionable how impactful oil prices may be for other state budgets as various articles provide various suppositions. According to some, many top producing oil states, such as Texas, California and Oklahoma, enjoy the benefits of a more diversified economy. However, the council on Foreign Relations suggests that Wyoming, Oklahoma and North Dakota stand to lose the most jobs if oil prices continue declining. Alaska, North Dakota and Wyoming are more reliant on gas and oil for the operating budget. Other states that count on gas and oil revenue have significant reserves to offset the price downturn.

Alaska has no state sales or income taxes as oil funds a majority of Alaska's state budget. For fiscal year 2013, the Alaska Oil & Gas Association reports that gas and oil revenues represent 92% of Alaska's unrestricted revenue. No other state comes close to this reliance. However, Alaska's current safeguard is their considerable reserves of 233% of operating revenue.

Louisiana appears to rely less on oil (15% of the general fund budget), yet has much less reserves on hand to cushion a prolonged oil price decline. The state has important offshore drilling which is less reliant upon short-term oil prices, and may benefit in its petrochemical industry from falling oil prices.

Mississippi and Montana derive only 1.5% and 6% of general fund revenue from oil tax revenue. New Mexico's direct revenue from oil and gas receipts is approximately 16% of their general fund budget. They have budgetary balance and the ability to withstand lower oil prices and slowdown at least in the near term.

The point is that overall, the states are poised to withstand short-term oil and gas depressed pricing. Most of the budgets are positioned to absorb the slowdown. As depicted in the left-hand column, most of the affected states maintain reserves in both oil and gas. In addition, the reliance on oil is mostly a less than critical component of the overall general budget. *(continued)*

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The length and extent of this oil price decline will determine its severity; however, there are also positive effects with lower prices. Lower gas prices could translate to more driving, toll revenue, fuel cost savings for corporations and governments, consumer savings and potential higher discretionary income to spend. Thirty-five states collect severance taxes of 1% or less on oil or coal extraction. Only 15 states have greater reliance on these taxes for their fiscal health.

Standard & Poor's published a paper on *"How Might the Oil Price Plunge Affect States' Credit Quality?"* They noted that states such as Alaska, North Dakota and Wyoming derive significant state revenues from oil-related activities. Additionally, New Mexico, West Virginia, Montana, Louisiana, Texas, Oklahoma, Kentucky, Utah, Mississippi, Alabama and Colorado all have severance taxes exceeding 1% of their state budgets. The good news is that Standard & Poor's reports that the ramification of an oil price drop has long been a part of their state credit quality assessment. As a result, this contingency has already been accounted for in their ratings. If oil remains low for longer, S&P will focus their attention on the fiscal response of the states to help determine what, if any, affect it may have on ratings.

The Takeaway: A drop in oil prices is being argued by some as an actual net positive to the overall U.S. economy and by others as a negative. Most states only see the benefits tied to reduced production costs consisting of transportation and/or operating efficiencies. For the states with gas and oil production, the realized impact may vary depending on the duration and severity of lower oil prices. A prolonged downturn could eventually impact employment and perhaps state revenues but most are well-positioned in the short-term and the immediate impact is offset by multiple factors such as reserves and exceptional budget planning and insight. ▪

"Neither a wise man nor a brave man lies down on the tracks of history to wait for the train of the future to run over him."

- *Dwight D. Eisenhower*

"If you take no risks, you will suffer no defeats. But if you take no risks, you win no victories."
- *Richard M. Nixon*

Kicker Bond (Cushion Callable)

The terms "kicker bond" or "cushion callable" are used interchangeably. This defensive strategy allows investors to pick up an above market yield-to-call (YTC) versus a comparable bullet (non-callable bond), along with a higher yield-to-maturity (YTM), or "kick", versus a bond with a similar final maturity. Kicker bonds are found in both the municipal bond sector as well as the taxable bond sector.

An example: If the current market yield for a 5-year, AA-rated municipal bond is 2.33%, a "kicker bond" might carry a much higher coupon versus the 2.33% with a call date around the same 5-year mark and a much longer maturity. For example, a comparison bond provides a 6.087% coupon and a maturity of approximately thirty-years. The strategy in this case, provides an investor with a 21.8% higher YTC, or an additional 51bp (2.84% vs. 2.33%) in yield. Accounting practices suggest writing the premium paid down to par to this call date. If the bond is not called, the investor owns a 6.087% coupon at par through the remaining holding period of the bond. The YTM of 5.108% theoretically outperforms a long maturity bond of similar attributes by 28% or an additional 112bp (5.108% vs. 3.99%) in yield. Whether the bond is called or extends to its maturity, the corresponding yields outperform a comparative bullet bond to the same date.

Bond Type	*Yld to 2/1/20*	*Yld to 2/1/45*
Bullet Bond (due in 2020)	2.330%	
Kicker Bond (due in '45, callable in '20)	2.840%	5.108%
Bullet Bond (due in 2045)		3.990%

For investors seeking ways to increase their yield during this low interest rate environment, kicker bonds provide the means. The higher coupon is a natural insulator during a rising interest rate environment. Higher coupon bonds tend to have less price volatility as rates rise. In addition, the higher cash flow streams generated by high coupons allow an investor earlier access to reinvest in the higher rate environment (assuming rates go up) as a portion of the high cash flow generated is actually return of principal. The strategy may provide added benefits to help optimize an investor's return during a very low interest rate period where investors are seeking ways to help boost their portfolio yields. Please contact your personal Raymond James advisor to provide more detail and currently offered examples. ▪

Zero Coupon Bonds

The general strategy for investors positioning defensively for rising interest rates ordinarily takes the course of more protective high coupon bonds. That strategy is appropriate in this environment; however, isolated strategies and perhaps market opportunities still exist for investors seeking to accomplish a desired objective. Zero coupon bonds may afford a means to some extraordinary objectives within an investor's overall strategy.

When an investor's priority is not cash flow, but rather to maximize yield, zero coupon municipal bonds provide an interesting alternative. Tactically chosen zeros may offer higher yields versus their coupon-bearing counterparts, while still providing investors with the credit safety associated with municipal bonds. As with any specific investment product or strategy, zeros are not for everyone, but when applied to the right scenarios, they can be a valuable part of your financial plan to meet that special need. Note that the trade-off of lower upfront dollars might be offset with higher duration (more price volatility). When there is no intent on early liquidation, the trade-off may fit an investor's need.

Zero coupon bond strategies are ideal for college or retirement planning, or any other situation where consistent cash flow is not essential, and receiving a known principal amount at a specified date is desired (for example, 18 years from now when your grandchildren will be entering college). Zeros are unique instruments that allow you to invest a relatively small amount today and receive a larger lump sum payment at some point in the future. A zero coupon bond yielding 4% with a 20-year maturity would price at $45,639 today. In 20 years, the bond matures at $100,000 all with tax-exempt growth like any other municipal bond. The chart below depicts investments at various yields and years to maturity. This chart shows you how much money you would have to invest today, and at what yield, in order to receive $100,000 in a specific number of years in the future. ▪

"We cannot do everything at once, but we can do something at once."

- *Calvin Coolidge*

Amount invested today to deliver a $100,000 payment in the future.

YTM	*Years to Maturity*				
	5	10	15	20	25
2%	$90,573	$82,035	$74,301	$67,297	$60,953
3%	$86,261	$74,409	$64,186	$55,368	$47,761
4%	$82,193	$67,556	$55,526	$45,639	$37,512
5%	$78,353	$61,391	$48,102	$37,689	$29,530

Source: Raymond James

"Facts are stubborn things; and whatever may be our wishes, our inclinations, or the dictates of our passions, they cannot alter the state of facts and evidence."

- *John Adams*

Just A Word or Two…

Moody's Ratings – Better Than a Trend

There have been fewer and fewer Moody's downgrades trending since late 2013. The year ended even better as the number and par value of upgrades surpassed the downgrades. In the 4th quarter of 2014, Moody's raised ratings on 91 issuers ($16.8 billion) and lowered ratings on 87 issuers ($7.9 billion).

2013 was the first time Moody's upgrades have been higher than downgrades since 2008. The respectable 4th quarter looks to turn the trend as the 2014 year's totals still favored downgrades (564) versus issuer upgrades (360).

Proposed Puerto Rico Tax Change

The governor of Puerto Rico, Alejandro Garcia Padilla, has proposed a consumption tax to replace the current income and sales tax (which is pledged to the COFINA bonds). As a way of protecting the middle and lower class, he is recommending that medications, groceries, rents, mortgages and public higher education would be exemptions. The proposal is an attempt to meet the significant tax evasion problem head-on. By receiving far fewer tax returns, the Treasury can focus on the evasion problem.

Chicago

The Civic Federation (Chicago) which analyzes northeastern Illinois major local governments, reports that Chicago area debt has risen to $20.4 billion (up 59.2%) from 2004-2013. (City of Chicago, Chicago Public Schools, Cook County, Chicago Transit Authority, Forest Preserve District of Cook County, City Colleges of Chicago, Chicago Park District and Metropolitan Water Reclamation District).

California

California, now the world's 8th largest economy, will have at least $2 billion more in revenue this fiscal year than what is estimated in the budget. California now boasts a balanced budget hopefully ending an unstable decade. *(source: Bloomberg News)*

Defaults on Moody's Rated Municipal Bonds *source: Moody's*

- 1970-2007 avg. 1.3/yr; one-year default rate: 0.009%.
- 2008-2013 avg. 5.0/yr; one-year default rate: 0.030%.
- 1970-2013 one year default rate: 0.012%.
- 65% of defaults are healthcare and multi-family housing.
- Recovery Rate: 64% (although ranges from 0% to full recovery)
  - Jefferson County, AL (September 15, 2008; $3.47billion) – recovery 54%/sewer warrants; 84%/GO.
  - City of Stockton, CA (June 28, 2012/$303million) - recovery pending; current proposal average 50%.

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- West Penn Allegheny Health System, PA (April 30, 2013/$710million) - recovery 87.5% of par on 85% outstanding bonds; pending status and recovery on remaining bonds.
- City of Detroit, MI Certificates of Participation (June 14, 2013/$1.45 billion) - recovery pending; city filed motion to repudiate the certificates which would result in 0% recovery.
- City of Detroit, MI Limited Tax and Unlimited Tax GOs (July 18, 2013) – recovery pending; 74% on GO ULT, 15% GO LT.

- A typical default was rated in the bottom 5% one year in advance of the default and the bottom 12% rating five years in advance of the default.

2015 Municipal Volume Trending Up

Municipal volume for January was up almost 40% from 2014 to $27 billion. More than 50% of the volume accounted for and was driven by a surge in refunding activity. New money issuance in January was down nearly 30% from 2014 according to the Bond Buyer. Since January is typically a slower month, some market watchers consider this a good sign for 2015.

President Obama's Proposal May Boost Infrastructure Spending

In January, President Obama proposed a new program to boost infrastructure spending: Qualified Public Infrastructure Bonds (QPIBs). That's good news for municipalities and municipal investors provided that Congress passes the required legislation. The President's proposal has no issuance caps, no private use test and the bonds are not subject to AMT. These types of projects tend to generate good paying jobs.

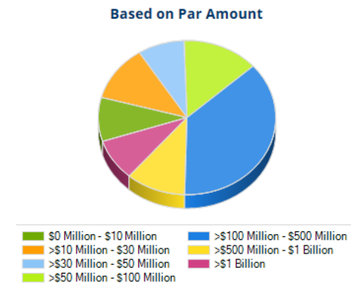
Municipal Performance *source: Bloomberg LP*

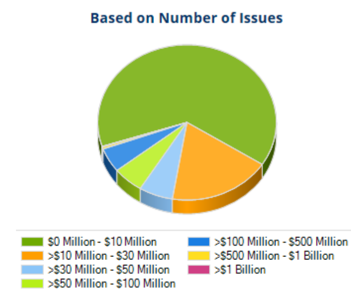
Last year, municipals posted their biggest returns since 2011. The BAML US Municipal Securities Index returned 9.78% for the year, the third best performance in the past decade. In addition, every major market segment posted positive gains for the year.

More on Raymond James' Market Position *source: Bloomberg LP*

In addition to being ranked in the top 10 underwriters for 2014 nationally when measured by dollar amount (see page 2), Raymond James also ranks in the top 3 in seven different states: Texas (3rd), Connecticut (2nd), Mississippi (1st), Tennessee (1st), Louisiana (2nd), Rhode Island (2nd), and Maine (3rd). ▪

New Issuance by Size: January to December 2014





Source: Emma

"He who knows nothing is closer to the truth than he whose mind is filled with falsehoods and errors."

- *Thomas Jefferson*

Fixed Income Misconceptions

Situation	Explanation
The 10-year Treasury currently yields 2%	**What it does NOT mean:** If you invest in a 10-year Treasury today, in 10 years, when the bond matures, you will have made a 2% return on your investment. **What it means: I**f you invest in a 10-year Treasury today, you are going to earn 2% annually for the life of the bond, for a holding period return (total return) of ~20%.
A bond's modified duration of 5	**What it does NOT mean:** This bond matures in 5 years. **What it means:** Modified duration tells you a bond's sensitivity to interest rate changes, specifically, the effect that a 1% change in interest rates will have on your bond. So for a bond with a modified duration of 5, it means that if interest rates rise 1%, the market value of this bond will fall approximately 5%. Conversely, if rates fall 1%, the market value of this bond will rise approximately 5%.
Buying a bond at a premium (price over par)	**What it does NOT mean:** That you lose money at maturity because you paid more than the maturity value of the bond. **What it means:** It simply means that you paid a price over par; most likely because interest rates were lower at the time of purchase than they were when the bond was issued. Given that you outlay the exact same dollar amount at purchase on three different bonds with the same exact yield (5%), same maturity, and constant rates, a discount, par, or premium bond will all net the same return of money throughout the life of the bond, the only difference is in the timing of when you get your money back (the premium bond is going to give you more of your money back sooner, in the form of bigger coupon payments).
The market value of my bond falls below what I paid for it	**What it does NOT mean:** That you lost money on this bond. **What it means:** Simply that the market value has fallen; the only way that this will translate into a loss, is if you choose to sell the bond. No matter what happens to the market price of the bond, if you hold it until maturity, you will still earn the yield at which you purchased the bond and receive par back at maturity. The interim prices only matter if you choose to sell prior to maturity.
I buy a bond today and rates begin to rise next year	**What it does NOT mean:** That you should have waited until the next year to invest **What it means:** Market timing is impossible. No one (not even the "experts") knows what interest rates are going to do tomorrow, next month, or next year (take a look at these experts' predictions for interest rates at the beginning of 2014). But two things are certain: 1) if you choose to sit on the sidelines until rates move to where you want them to be, you are going to miss out on any income that you could have received between now and this mythical future date; 2) if you do not invest today, rates HAVE to rise tomorrow (or next month, or next year) in order for you to be better off because you chose to wait. In addition, the amount that rates need to increase in order for you to break-even (had you invested today) is probably more than you would think.
Interest rates are near all-time lows	**What it does NOT mean:** Bonds are doomed to lose money and are currently a riskier investment than equities. **What it means:** First, there is no guarantee that interest rates will rise in the foreseeable future. Second, the DJIA has seen falls of 31.49%, 53.77%, and 16.82% since 2002 compared to the bond market (using the iShares Core U.S. Aggregate Bond ETF or AGG) that has only seen one fall of more than 10% over that same time frame (13.18% in 2008). You can decide for yourself which asset class appears riskier and where you would want to invest your money for safety of principal. Third, timing the market may be less important in the bond market than in the equity markets. If you buy a bond today yielding 5% that matures in 10 years, you know the return that you are going to get over the next 10 years (barring default) no matter what happens in the markets. Equities do not tell the same story, as you must have good timing and luck on when you enter and exit the market in order to get the return that you desire. Past performance does not guarantee future results.
The dividend on a stock is higher than the interest rate on a bond	**What it does NOT mean:** It is a no brainer that you should buy the stock, because it is currently yielding more than a bond you are comparing it to. **What it means:** You need to decide what the purpose of this investment is. If your goal is for principal growth along with income, and to have this possibility for growth, you are willing to take the risk of incurring a significant loss to your principal as well as the risk that the dividend rate could get reduced, then buying the stock might be the right decision. If your goal is principal preservation along with a predictable and known income stream, then maybe buying the bond is the logical choice.
Cash Flow & Income	**What it does NOT mean:** Cash flow = income **What it means:** Cash flow represents the coupon payments that you receive (usually semi-annually) when you own a bond. The income that you make from owning a bond is calculated from the yield at which you purchase the bond. So if you buy one bond (par value=$1,000) maturing in twenty years with a 5% coupon and a yield of 2.5% (this bond would be purchased at a premium), your cash flow will be $1000, but your income from this bond will only be $500.

The author of this material is a Trader in the Fixed Income Department of Raymond James & Associates (RJA), and is not an Analyst.

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