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MUNICIPAL BOND MARKET UPDATE

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THE FLOCK TOWARDS HIGH YIELD

features

ILLINOIS VS. NEW JERSEY

Municipals continued to perform well in May due primarily to positive fund flows, favorable market technicals, and falling interest rates. Credit spreads collapsed even further as the search for yield continues (Figure 1). Long duration, credit, and Puerto Rico were the best performers in May as well as year-to-date (Figure 2).

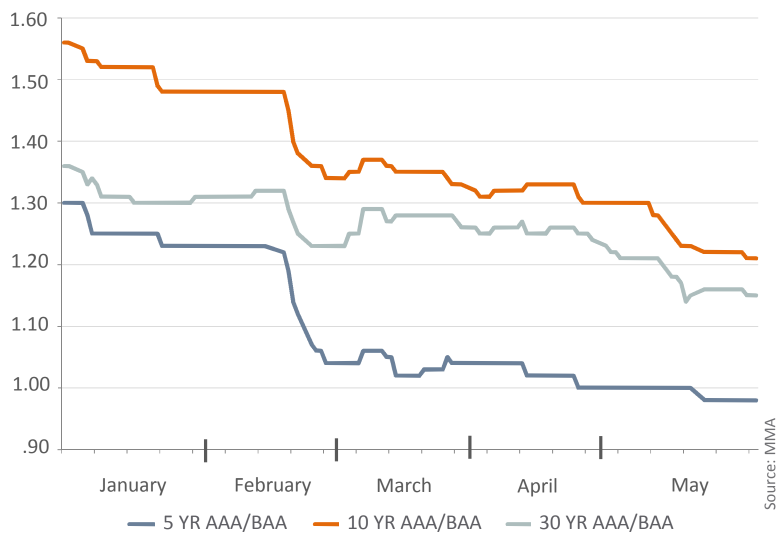
Supply for the month of May totaled approximately $25bn, falling from around $26bn the month prior. May of 2013 saw total supply of $30bn, representing a decrease of nearly 16% for this May. Several notable events unfolded in May:

- May 1: Fitch downgraded the State of New Jersey to A+.
- May 9: Puerto Rico announced that tax revenues fell unexpectedly by over $350M. Despite this revenue miss, Puerto Rico bonds rallied over 4.50% for the month as evidenced by the Barclays Puerto Rico index.
- May 22: Announcement that Detroit will receive oversight as it exits bankruptcy.

In the 3 year range, municipal yields moved lower by 4 basis points to yield 0.58% while Treasury yields in the same range fell 8 basis points to yield 0.77%. This puts municipal yields at 75% of the Treasury yield, up from 72% from the previous month.

In the 10 year range, municipal yields moved lower by 11 basis points to yield 2.19% while Treasury yields in the same range fell 17 basis points to yield

FIGURE 1: CREDIT SPREADS



	12/31/2013			4/30/2014			5/31/2014			YTD Change		Month Change	
Year	MUNI AAA	Treasury	% of Treas.	MUNI AAA	Treasury	% of Treas.	MUNI AAA	Treasury	% of Treas.	MUNI AAA	Treasury	MUNI AAA	Treasury
3 yr	0.51	0.77	66.23%	0.62	0.85	72.94%	0.58	0.77	75.32%	0.07	0.00	(0.04)	(0.08)
5 yr	1.24	1.74	71.26%	1.23	1.68	73.21%	1.17	1.54	75.97%	(0.07)	(0.20)	(0.06)	(0.14)
10 yr	2.77	3.03	91.42%	2.30	2.65	86.79%	2.19	2.48	88.31%	(0.58)	(0.55)	(0.11)	(0.17)
30 yr	4.19	3.97	105.54%	3.49	3.46	100.87%	3.28	3.33	98.50%	(0.91)	(0.64)	(0.21)	(0.13)

Data Source: Bloomberg

FIGURE 2: BARCLAYS MUNICIPAL INDEX PERFORMANCE

Index	MTD Total Return	YTD Total Return	Total Return 3 Month	Total Return 6 Month	Total Return 12 Month
Municipal Bond Index	0.17	3.32	2.68	5.63	3.05
1 Year (1-2)	0.04	0.24	0.20	0.44	0.84
3 Year (2-4)	(0.36)	0.33	0.24	0.93	1.59
5 Year (4-6)	(0.85)	1.00	0.36	2.07	2.34
7 Year (6-8)	(0.70)	2.02	1.42	3.92	3.13
10 Year (8-12)	(0.05)	3.13	2.54	5.52	3.69
15 Year (12-17)	0.48	4.32	3.56	7.32	4.26
20 Year (17-22)	0.72	4.74	4.05	8.04	3.51
Long Bond (22+)	0.86	5.83	4.72	9.19	2.94
AAA	(0.11)	2.22	1.83	4.03	2.82
AA	0.07	2.95	2.42	5.16	3.25
A	0.31	3.91	3.10	6.58	3.65
BAA	0.82	5.52	4.57	8.18	(0.09)
Puerto Rico	0.95	8.22	6.18	8.21	(11.39)

Data Source: Barclays

2.48%. This puts municipal yields at 88% of the Treasury yield, up from 86% the month prior.

In the 30 year range, municipal yields moved lower by 21 basis points to yield 3.28% while Treasury yields in the same range fell 13 basis points to yield 3.33%. This puts municipal yields at 98% of the Treasury yield, down from 100% the month prior.

The lop-sided supply and demand imbalance continues to favor lower rates. Additionally, mutual fund flows continue to put pressure on rates, especially high yield fund flows. We remain cautiously optimistic that municipals will perform well in the coming months.

ILLINOIS VS. NEW JERSEY: RACE TO THE BOTTOM

If Illinois and New Jersey were in a competition for most fiscally unstable state, they couldn't be doing a better job. That is not to say that these two states are in the worst condition of all; there are a few others on our radar. Yet, as far as large municipal bond issuers go, they are currently a couple of our more significant concerns.

To be clear, we do not expect either state to default on any of its general obligation or appropriation debt. However, fiscal irresponsibility produces rating changes and price volatility. Because in this case we are more concerned with price volatility than default, forecasting the rating agency actions gives us the ability to be more opportunistic.

Below we look at three metrics that both aid us in comparing the two states and factor heavily into rating agency ratings: revenues and spending, the budget, and pensions. Although there are many other metrics that we and the rating agencies use to evaluate credits, we believe these will have the largest effect on ratings.

REVENUES AND SPENDING

ILLINOIS

Moody's: A3 [Negative Outlook]

S&P: A- [Developing Outlook]

When the personal income tax rate was finally increased from 3% to the much needed 5% in December 2010, Illinois' backlog of unpaid bills was $9.9 billion and it took 18 months to two years for vendors to be paid. Since the personal income tax rate was increased, the pile of bills has declined to $6.7 billion. A tax increase that generated about $15 billion in additional revenue reduced the backlog just $3 billion? Where did the money go?

The tax increase did help the state progress to a degree or, perhaps a better term might be, sink more slowly. The higher tax rate enables the state to pay some bills and its debt issuance to close budget gaps (aka "deficit financing") has been reduced significantly. In addition, its cash position, while still negative, has improved each year since the tax increase. Still, the state continues raiding funds destined for other purposes to make some payments, and is far from fiscally balanced.

While the biggest issue here is Illinois' inability to live within its means, the problem hurtling towards us like a freight train is that the tax increase sunsets December 31st, 2014. Governor Quinn's budget office is projecting the bill backlog could hit **$16.2 billion** in the next three years if the 5% rate is not extended. Note the implication: spending will not go down. That's the size of about half of the general fund budget of the state. The state legislature was unable to pass an extension and, depending on who will win the gubernatorial election this Fall, we cannot be certain it will be extended.

NEW JERSEY (APPROPRIATION DEBT)

Moody's: A2 [Negative Outlook]

S&P: A [CreditWatch with Negative Implications]

Governor Chris Christie has not increased any taxes, having learned from his predecessor that even a temporary increase promises losing office. The highest tax rate is 8.87% for income over $500,000. The next bracket is 6.37% for income over $75,000. New Jersey residents have a high overall tax bill, with some of the largest property tax burdens in the country, offering less flexibility for raising taxes.

While Governor Christie has closed some tax loopholes, the slight revenue increases that he has managed to wrangle out of a state still struggling to crawl out of the recession have led to barely any growth. At the same time, expenses each year are consistently higher.

The state's cash position is weakening, adding to its lack of flexibility. For a state that uses an unusually high amount of Revenue Anticipation Notes (RANs), this can become a credit, and rating, issue.

THE BUDGETS

ILLINOIS

In mid-May, the Legislature passed the fiscal 2015 budget based on the assumption that the 5% tax increase would be extended past its December 31, 2014 sunset. That assumption of taxing the full 12 months at 5%, instead of just six months, added about $2 billion of revenues to the budget.

But then two weeks later, the same Legislature was not able to pass the tax rate extension. So, on January 1, 2015, the personal income tax rate is set to decline to 3.75%.

Now, we have an already precariously balanced budget with a new $2 billion hole - about 6% of the budget. This will be the twelfth year in a row that Illinois closed the year with a general fund deficit, according to the State Comptroller. But we should note that the budget does take into account payment of its full required pension payment.

NEW JERSEY

Since the state's February budget announcement, it has identified an additional $1 billion budget gap - about 3% of the current year's budget. With one month left in the fiscal year, structural balance is a far reach. For the 2015 fiscal year, which begins July 1st, the state has reduced its revenue forecast by an additional 5%. The governor has decided to close the budget gaps by not paying into the pension - after the same administration enacted the reforms for pension contribution in the first place.

Governor Christie has made it clear he will veto any personal income tax increase, including the temporary "millionaires' tax" the state once used. As usual, expenditures will be rising, but there is no revenue to balance the spending.

Under Governor Christie, the budgets have become more and more structurally imbalanced with a growing use of one-time gimmicks, broken promises, and raiding of other funds to cover gaps.

PENSIONS

ILLINOIS

Decades of unsustainable promises led Illinois to have the lowest funded pension of any of the 50 states at 39% as of fiscal year end 2013. This is not news. But this past December, Governor Quinn signed a pension reform bill which made a number of changes to the pension benefits. These changes are calculated to save the state $160 billion over the next 30 years and fully fund the pension by 2044. Importantly, the law gives the **unions the right to sue if the state falls short on its pension funding requirements**.

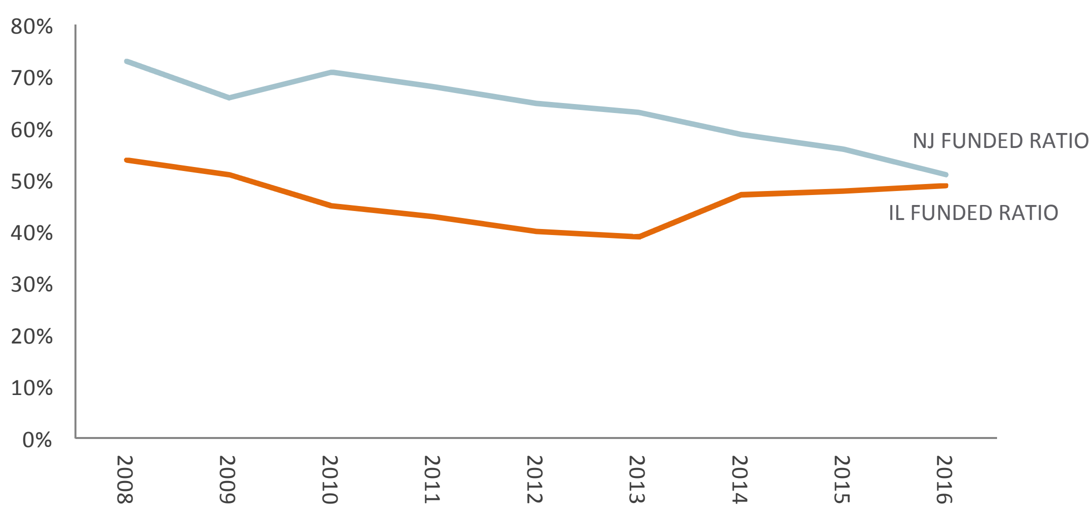
To understand the burden on the state, full actuarially required payments will take up 15%-18% of the state's general fund budget. That's $7-8 billion - almost twice what the increase in income tax rate brought in! While the pension law is an incredible step forward, a pension payment that large will put significant strain on the state budget and make it even more inflexible.

Because the pension law also cut pension benefits, public sector unions have already filed suit stating that the law violates the state's constitutional ban on decreasing benefits to state pension members. In our opinion, this seems wildly inappropriate as the cuts weren't that severe. As a pensioner, we would take more comfort from a smaller pay out, with confidence that the checks would keep coming, than a larger unsustainable promise we cannot count on.

NEW JERSEY

In 2011, the current administration created a pension reform law to get back on track with its pension payments gradually over seven years. The plan called for paying at the following schedule: year one, one-seventh of the required payment, year two, two-sevenths, and so on. While it's nice to have a plan, this plan is weak. It kicks the can down the road, making the burden heavier in later years.

FIGURE 3: FUNDED PENSIONS: ILLINOIS VS. NEW JERSEY



Data Source: State of IL and State of NJ

Fiscal years 2014 and 2015 are the third and fourth years in this plan, and already Governor Christie is claiming he is going to pay just a fraction of the fractioned amount. The plan, by design, would increase the unfunded liability, but that unfunded figure just became much greater. So great in fact, that if Governor Christie cuts the pension payments as he has broadcasted, Illinois will lose its distinction as the state with the lowest funded pension in 3-4 years (see Figure 3).

Were New Jersey paying its required contribution, it would take up 12% of the budget. On the reduced schedule, 2014 and 2015 pension payments require 4% and 6.5% respectively. A single digit pension payment is usually manageable - and acceptable to rating agencies - but New Jersey is shirking even on this.

WHAT WILL HAPPEN?

ILLINOIS

In order to stabilize its current ratings, the state needs to extend higher personal income taxes and receive a green light on the pension legislation from the courts.

The first is mainly dependent on the gubernatorial election this fall. If Governor Quinn is reelected, we expect he will call a special session to vote on an extension of the tax at a higher rate than the default 3.75%. Bruce Rauner (R), running against Governor Quinn, is against increasing the tax, although he has not offered an alternative budget plan.

The timing and outcome of the court ruling on pension treatment will likely be drawn out and we have seen rational arguments supporting both sides. But the good news is that in the mean time, the state will be making larger payments into the pension fund.

Without confirmation of the pension law <u>and</u> a reduced personal income tax rate, we expect rating agencies to downgrade the state to the BBB/Baa category. We believe it is likely that at least one rating agency will downgrade if both do not occur.

However, with the next governor's term beginning January 1st, we expect some increase in the personal income tax rate at least temporarily as there will be few other choices six months into the fiscal year.

NEW JERSEY

New Jersey is likely to be downgraded if it passes budgets with decreased pension contributions as it has stated. The overconfident revenue forecasts of the past few years have ended each year with a scramble to close gaps with one-time fixes, draining the state and making its cash situation weaker. Governor Christie has already seen New Jersey downgraded 6 times between Moody's/S&P/Fitch (to be fair, Illinois has seen 13 downgrades under Governor Quinn).

Note that while a one notch downgrade would put New Jersey's general obligation debt one notch above Illinois, the appropriation debt - the debt actually trading regularly - will be on par.

CONCLUSION

Both states are weak. Whether tax rates increased or not, expenses rose. Illinois is attempting to make changes to stabilize itself but the outcome is still unclear. New Jersey looks like it just stopped trying as its management continues to make poor fiscal choices.

The rating agencies are poised for downgrades, waiting to see budgetary outcomes in the case of New Jersey, and legislative and legal outcomes, in the case of Illinois. We expect to see rating action on New Jersey before Illinois, but both within the year.

Regardless we expect that any downgrades will in no way reflect the states' ability and willingness to pay their general obligation and appropriation debt. But rating volatility often translates into price volatility, and preparing for rating agency changes in credits which we believe to be very default remote gives us the opportunity to prepare our strategy to make the most of our anticipated market changes.

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