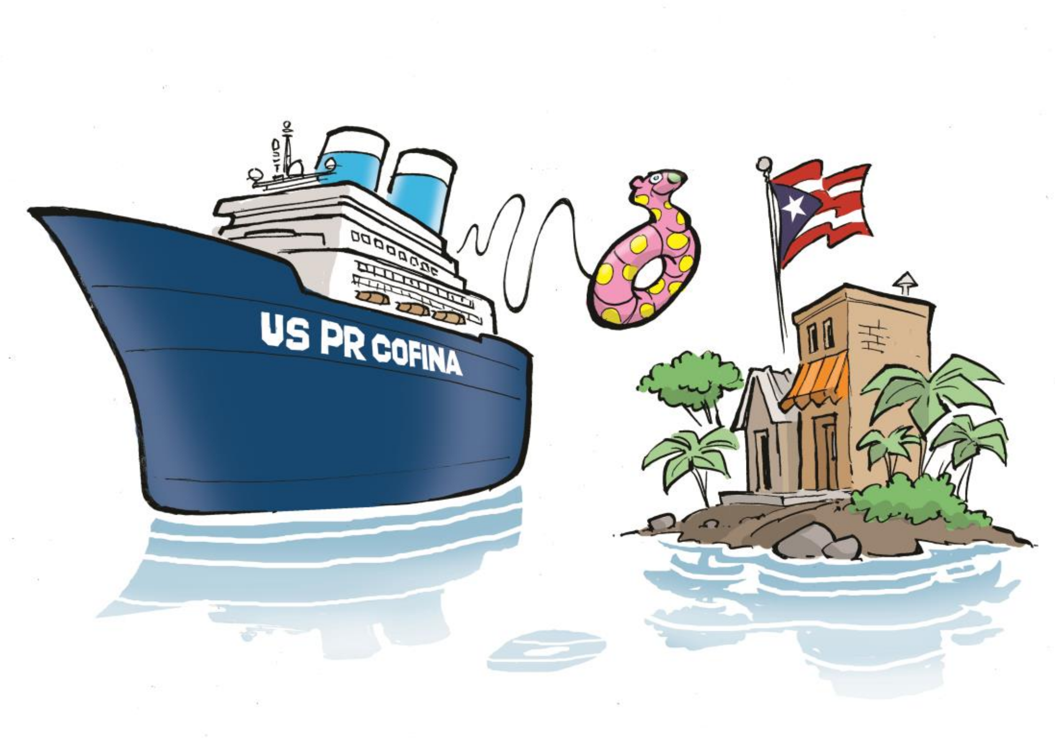
The government shutdown ended in October but not before delaying economic data for a week. This month, muni rates moved lower and several credits continued to make headlines. We created the cartoon below to reflect a credit situation that we are watching closely. We hope you enjoy it and the many more to come!



Source: Asset Preservation Advisors

CREDIT MARKETS

Puerto Rico's COFINA Expansion

The Commonwealth of Puerto Rico continues to appeal to investors, emphasizing that it is ready, willing and able to pay its debt. The Commonwealth hosted an investor phone call in early October in an effort to increase transparency and subsequently took out a full page ad in the Wall Street Journal in an attempt to change the current market perception that it could default or restructure debt. Furthermore, legal experts from the GDB's fiscal team, along with two legal firms, hosted another conference call asserting that Puerto Rico's COFINA (sales tax) bonds would not be subject to a "claw-back" by GO bond holders. The COFINA bonds have long been considered to be a stronger credit in Puerto Rico due to the dedicated sales tax revenue stream supporting the bonds; however, at the beginning of October, Moody's downgraded the bonds two notches from Aa3 to A2, to bring the rating closer in line with the general obligation rating of the Commonwealth (rated Baa3/Neg). This downgrade prompted many investors to question the constitutional validity of the independence of the COFINA revenues.

The GDB conference call with attorneys seemed to focus on two themes (a) GDB officials wanted to re-iterate the legal strength of the COFINA revenue pledge in anticipation of a recently approved 3rd lien debt issue and (b) GDB officials wanted to introduce the concept of COFINA as a MAC-like structure that can help the Commonwealth of Puerto Rico out of its current fiscal crisis. MAC (Municipal Assistance Corporation) was an entity that came out of the New York City fiscal crisis of the 1970s and enabled NYC to issue debt backed by specific revenues. The creation of MAC is often considered a primary reason NYC was able to avoid bankruptcy; it enabled the beleaguered city to access capital markets and gave the city much some needed financial flexibility. While there are stark differences between NYC of the 1970s and the Puerto Rican Commonwealth of today, there is some merit to the idea that COFINA could be used as the lifeline out of their current fiscal crisis. However, as the main challenge to Puerto Rico is still prolonged lack of economic growth, the additional COFINA financial flexibility alone is unlikely to be enough to put Puerto Rico back on solid financial footing.

Detroit's Bankruptcy Hearings

Detroit started its bankruptcy eligibility hearing with a 9 day trial to determine whether or not the city could move forward with Chapter 9 proceedings. The central theme throughout the hearing was the eligibility question and whether or not the city had in fact negotiated in good faith with their creditors. The city maintained that it had negotiated in good faith, while simultaneously asserting it was impossible to do so. Both sides have until November 13th to file additional arguments outlining support for their respective cases. The judge, Judge Rhodes, has indicated that he will make a ruling soon. It has been widely anticipated that the city would be able to move forward into Chapter 9. However, at the hearing, Judge Rhodes seemed intent on questioning how the city had truly negotiated in good faith with such a speedy rush to bankruptcy proceedings. We continue to expect that this is just the beginning of a long road to bankruptcy and beyond for the city of Detroit.

Back in Action

Zombies were not the only thing coming back from the dead around Halloween this year as new bond offerings came to market from Jefferson County, Alabama and Vallejo, California. Vallejo was one of the first cities to use Chapter 9 in recent years to restructure its debt and subsequently move through and out of the bankruptcy process. The new deal will refinance $19 million in water revenue bonds secured by water system revenues, which did not default on any payments throughout the bankruptcy process. Jefferson County, Alabama (the largest municipal bankruptcy prior to Detroit) is also marketing a deal expected to price later this month; however, this deal is part of their emergence from Chapter 9 bankruptcy protection. The county hosted a conference call the first week of November with investors, making a case for the newly re-organized county management and finances. If the deal is successful, it will enable the city to refinance $3.14 billion in outstanding sewer warrants. Muni market participants will be closely watching how these deals price and trade in the market as it may shed some light on the question of market access for previously troubled municipalities.

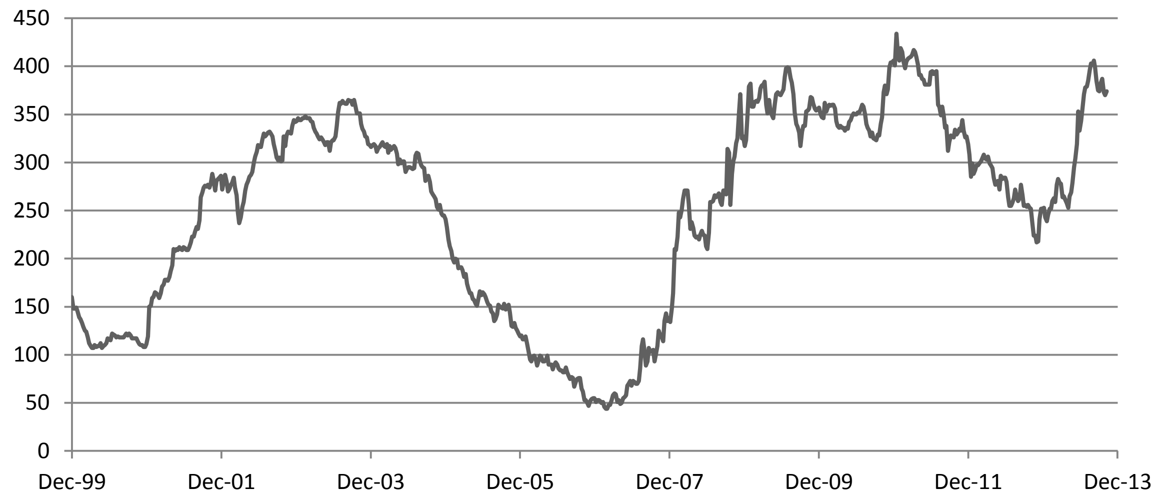
TRADING MARKETS

October 1st marked the beginning of the first government shutdown in 17 years; however, the muni trading market was largely unaffected. The market continued its momentum from late September moving towards lower rates. As most of the market realized that Washington was at an impasse, market participants began to focus on a larger primary calendar which lead to some much needed price guidance. The secondary market closely followed with a stronger bid on most deals, matching the new found interest on any block item for the bid or offered by an account. This led to dealers to active bidding and taking on more inventory causing spreads to tighten (especially inside 10 years) with the largest compression seen in the 5 year range.

As the Washington saga was making little progress through the middle October, fund flows, though still negative, were beginning to slow and higher yielding names, including Puerto Rico, were beginning to catch a firm bid. This scenario lead to some much anticipated out performance of municipals over the treasury market. Municipal fund flows reached a new record, surpassing the post Meredith Whitney scare, but soon ground to a slow leak, a much improved pace from the fire hydrant like exodus of the prior months.

November is usually characterized by positive price movement; the only exception since 2005 was in 2010 (almost as bad as 2013) fund outflows. New issuance may pick-up a bit heading into year end, with underwriters attempting to take advantage of the lower rates. However, as long as there is no surge in redemptions reminiscent of the summer months, the supply should be very manageable for the large amounts of cash still looking to be put to work. November may be slightly a bit more volatile than usual with the back-up of economic data due to be released from the government shutdown, but with a somewhat range bound treasury market, fundamentals of municipals should carry the market through the month.

As equities continue to break new highs, economic numbers continue to leave many participants unimpressed and one has to wonder how much higher they can go and when the “great rotation” from bonds to equities will subside. The steepness of the yield curve (see chart on page 4) has rarely been this attractive and we continue to find opportunities to invest in areas where we see, not only a dislocation of credit pricing, but also maturity pricing.



Source: MMD

ECONOMIC AND POLITICAL MATTERS

New York has a new Mayor in town

New Yorkers elected a new mayor for the first time in twelve years on November 5th. The Democratic candidate, Bill de Blasio, won in a landslide election over the Republican contender, Joe Lhota. De Blasio is a self-described progressive liberal who also claims to be a fiscal conservative, focused on balancing the budget and "getting the best deal for the taxpayer". It is likely de Blasio will negotiate agreements with the several of the city's municipal unions who have been working without contracts for several years now and who also backed his campaign. He has indicated that he will focus on ending New York's affordability crisis. Yet, in various speeches he has conceded that balancing the budget would take precedence over pursuing his liberal agenda. We believe any new mayor, post the Bloomberg administration, will be a transition for the city; however, one of the city's greatest strengths is its institutionalized budgetary and financial management controls. The city's OMB has identified gaps of $2.0 billion, $1.8 billion and $1.4 billion in fiscal years 2015, 2016 and 2017, notably smaller than the gaps the city was able to close at the height of the economic downturn and small relative to the city's $66 billion total budget in 2012. Positively, in fiscal 2013, revenues are estimated to be 8.5% higher than FY 2012, fueled largely by an increase in personal income tax collections. De Blasio will need to prove to investors that he is serious about the financial health of NYC; nevertheless, we believe that the city has the internal controls in place and economic momentum to maintain its fiscal health in the near to medium term.

Economic News indicates continued low rates

Unemployment data was unexpectedly better than expected when released on November 7th, a week late due to the recent US Government shutdown. Employers added 204,000 jobs when only 120,000 were expected, while the unemployment rate ticked up one basis point to 7.3%. However, conflicting data showed that the labor force participation rate is the lowest it has been in the US since March of 1978 at 62.8% as more people continue to give up the search for a job. Additional positive economic data came from the Gross Domestic Product (GDP) as it rose 2.8% in the third quarter, outpacing the expected 2% growth and marking the fastest growth in a year. Yet the uptick will likely still not dissuade officials at the Fed to scale back the QE3 stimulus program anytime soon. The expected next Chairwoman of the Federal Reserve, Janet Yellen, is said to be as dovish as Bernanke and focused on seeing true improved fundamental economic data (especially unemployment falling to 6.5%) before scaling back the program. Furthermore, in the beginning of November, two papers were presented at the Federal Reserve that suggested the Fed should possibly maintain its bond-buying program even longer, until unemployment falls to 5.5%. This suggests we will likely continue to be in the current low rate environment for the foreseeable future.

CONCLUSIONS

Municipal bonds continue to remain an attractive sector when compared to treasuries and the credit stories only continue to get more interesting. This month, previous bankrupt municipalities are testing their feet in the water for market access, while Puerto Rico attempts to pull another rabbit out of its hat of financial tricks. While Washington called a temporary truce last month and ended the government shutdown, it essentially only postponed the debate until January 2014. The Affordable Care Act's rollout continues to make headlines and should only fuel the looming debt ceiling and budget talks in the coming new year. All of these events, coupled with the approval process of new Chair of the Federal Reserve in November, lead us to believe the market will remain at its current lower rates in the near future and there continues to be great value in Munis.

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