Municipal Market UPDATE

March 5, 2014

SternBrothers&Co.
INVESTMENT BANKING SINCE 1917

- **February Muni Volume Lowest in 14 Years**
- **Variable Rate Market Remains Stable at Low Levels**
- **State and Local Governments Slowly Improving**

February Muni Volume Lowest in 14 Years

Fueled by a 62.9% decline in refundings, muni issuance reached the lowest levels for the month of February since 2000. February 2014 witnessed only 633 transactions totaling $14.7 billion, which is a mere 40.4% drop from February 2013, which saw 1,035 issues totaling $24.7 billion. New money issuance increased by a very slight .7% from the same period last year, with 403 issues totaling $9.6 billion.

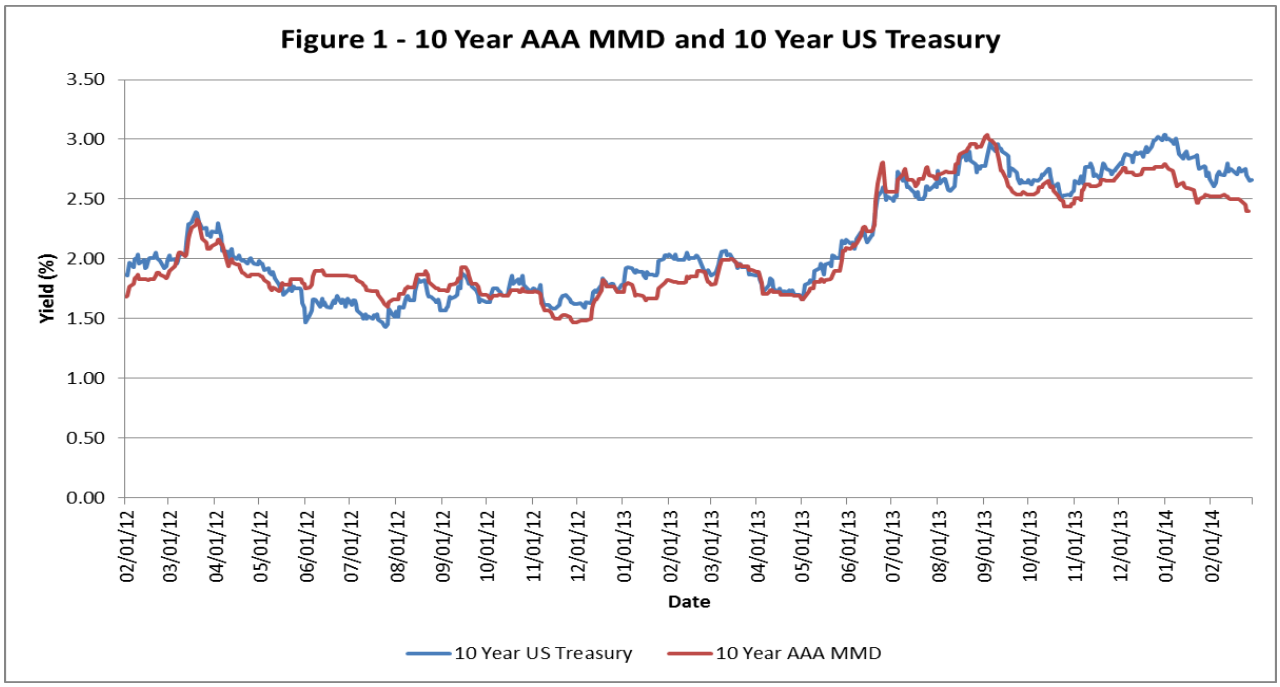
The Municipal Market Data ("MMD") 'AAA' Muni Market 10 year yield ended February at 2.40%, 13 basis points ("bps") below where it stood on February 3rd; the 30 year yield also fell 13 bps, from 3.85% at the beginning of the month to 3.72%.

In February, the 10-year US Treasury yield was up 5 basis points ("bps") from 2.61% to 2.66% at the end of the month. The 30-year Treasury yield was also up, increasing 5 bps for the month; finishing February at 3.59%, up from 3.55% on February 3rd.

As of February 28th, the ratios of 'AAA' General Obligation municipal yields to Treasury yields were:

Year	Yield	% Yield
1-Year	0.15 / 0.12	125%
5-Year	1.00 / 1.51	66%
10-Year	2.40 / 2.66	90%
30-Year	3.85 / 3.59	107%

Sources: The Bond Buyer, Bloomberg, US Department of Treasury, US Federal Reserve



Source: Bloomberg & US Department of Treasury

Variable Rate Market Remains Stable at Low Levels

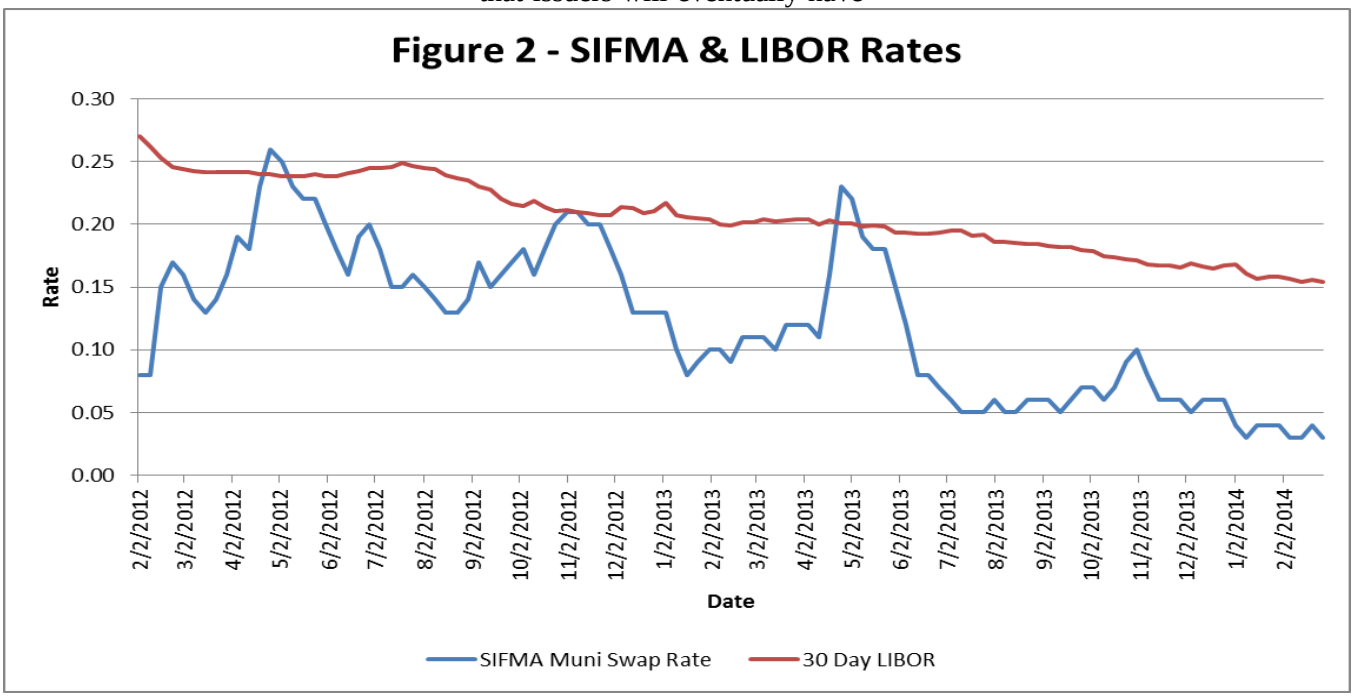
The SIFMA Municipal Swap Index, an average of high-grade, tax-exempt, variable rate bonds, remained relatively stable at record low levels throughout the month of February, dropping as low as .03% and finishing the month at .04%. The 30-day LIBOR rates decreased in February, beginning the month at .15650% and ending .15450%. Please refer to Figure 2 below for historical SIFMA and LIBOR rates.

Sources: The Bond Buyer, Bloomberg, SIFMA

State and Local Governments Slowly Improving

The City of Detroit, in the midst of the largest Chapter 9 municipal bankruptcy filing in U.S. history, filed its proposed plan of reorganization with the federal bankruptcy court on February 21st.If enacted, this proposed reorganization has the potential to reverberate across the municipal bond markets for years to come. Detroit's proposed treatment of its various classes of creditors could serve as the impetus for investors to rethink the true level of risk inherent in municipal bonds with the result that issuers will eventually have to pay higher interest rates to borrow funds.

The catalog of Chapter 9 bankruptcy filings is short and not an especially entertaining reading. The section of the U.S. Code devoted to allowing municipalities to restructure their debt and other obligations has rarely been invoked and even more rarely has it resulted in any meaningful reductions to publicly held debt. So lacking much in legal precedent to help predict the likely outcomes of municipal bankruptcy filings, investors have tended to accept the legal protections offered by bond covenants at their face



Source: Bloomberg & US Department of Treasury

value. For General Obligation bonds (G.O. bonds) this has included the belief that if a municipality is unable to make their debt service payment, the political body would raise taxes until the funds were available. If they refuse to do so, it has long been theorized, the bondholders could go to court and a court order would quickly follow ordering them to do so. It has been this ability to appeal to the courts for a *Writ of Mandamus* that has supplied the actual "full faith and credit" of a bond issuer to its G.O. bonds, not any actual faith in or credit for the politicians that sign the checks.

Detroit, however, finds itself in a situation that no other Chapter 9 filer has been in before. With its population losses over recent decades, there are not enough residents left to tax, at least not at a level that wouldn't drive away the remaining taxpayers with the resources to actually pay. So Detroit has asked for steep "haircuts", or reductions in principal amounts outstanding, for their G.O. bonds. The city's plan proposes to settle at about 20% of face value for its G.O. bond holders. The city's appropriation bond holders are looking at an even lower settlement amount. The controversy arises due to Detroit's emergency city manager seeking to impose less severe haircuts on the city's pension plan participants, in the 66%-96% range according to Moody's Investors Service. G.O. bondholders reading their bond agreements with the city would have never imagined that they were not at least equal in seniority to other creditors and most would state that they believed "full faith and credit" to make them senior to any other creditors. After all, there was no pledge to the city's unions to raise taxes if they fell behind in funding pensions like there are for G.O. bonds.

But Detroit's proposal is not without its merits to the people of Detroit. By all accounts, the city's pension payouts to retirees are reasonable and not of the sometimes excessive nature that have emerged from California bankruptcies. There may be more retirees than there should be for a city of Detroit's size, but there don't appear to be any 50 year-old retired firemen receiving $150,000 a year for the rest of their lives. As these former workers are not eligible for Social Security, the city's leadership can hardly be faulted for at least attempting to get the best deal for its residents that they possibly can.

Still, if the plan as proposed is accepted it will have far reaching and long lasting implications. As the only precedent available, it's not unreasonable to believe that case law will in the future assert that pensions are senior in priority to even G.O. bonds. This will have a large impact on the future availability of credit and interest rates for future municipal borrowers. An even more imposing possibility is the prospect of "strategic" Chapter 9 filings by cities to rid themselves of debt so that future tax dollars could be devoted to city services. If there are very few drawbacks and a lot of benefits to a Chapter 9 filing for a city's residents why shouldn't they vote for the candidate who wants to ditch the bondholders and build the new downtown transport system? Although that seems farfetched now, it was once farfetched that a company's management would file Chapter 11 just to offload their pension plans onto the PBGC, a now not uncommon occurrence.

So now everyone will wait and watch the events in Detroit unfold. There is every possibility that the city's proposed workout is just an initial offer and that they intend to be flexible with all of its

creditors, as would certainly be the case in a Chapter 11 corporate filing. But the indisputable difference is that in a Chapter 9, they don't have to be. Because the court must also weigh the long-term effects of the workout on Detroit residents, not a consideration in corporate filings, they could "cram down" an agreement on bondholders to the benefit of today's Detroiters, but to the detriment of the municipal bond market as a whole.

Sources: Moody's, Standard & Poor's, The Nelson A. Rockefeller Institute of Government

Source: Moody's and The Wall Street Journal

February 2014 Selected Bond Issues

General Obligation and Essential Service Revenue

Date	Par ($ mil)	Issuer	Project	Ratings	Final Maturity	Yield	Spread to MMD	Notes
3/1/2014	$7.88	Hopkins County TX	Public Improvements / Correctional Facilities Improvements / Property Acquisition	A2/AA-/	4/15/2035	4.000%	54	Insured by AGM & Bank Qualified
2/4/2014	$19.03	Hamilton County OH	Riverfront Infrastructure Improvements	Aa2/ /	9/1/2043	4.500%	65	
2/4/2014	$41.14	New York City Transitional Finance Authority	Public Improvements Refunding Bonds	A3/AA/	3/1/2032	4.400%	100	
2/6/2014	$27.08	Springfield IL	Public Improvements	A1/AA/	12/1/2029	4.420%	119	

Education Sector

Date	Par ($ mil)	Issuer	Project	Ratings	Final Maturity	Yield	Spread to MMD	Notes
2/13/2014	$53.69	East Carolina NC University	University & College Improvements	Aa2/AA-/	10/1/2043	4.390%	52	
2/13/2014	$54.34	Washington State University	University & College Improvements	Aa2/AA/	4/1/2039	4.120%		
2/13/2014	$30.85	Souther Illinois University	COP - University & College Improvements Series A-1	A3/A/	2/15/2034	4.770%	123	
2/27/2014	$39.41	Missouri State University Auxiliary Enterprise System	University & College Improvements	A1/A+/	4/1/2036	4.200%		
3/5/2014	$12.38	University of Oklahoma	University & College Improvements	/AA-/AA	7/1/2043	4.620%	91	

Water/Utility Sector

Date	Par ($ mil)	Issuer	Project	Ratings	Final Maturity	Yield	Spread to MMD	Notes
2/1/2014	$6.72	Oakmont TX Public Utility District	General Obligation Unlimited	A3/AA/	3/1/2032	4.400%	99	Insured by AGM & Bank Qualified
2/11/2014	$6.82	College Place WA	Water Utility/Sewer Improvements	/AA-/	12/1/2033	4.000%	47	Bank Qualified
2/12/2014	$48.50	Pima County AZ	Sewer Improvements	/AA-/AA-	7/1/2028	3.550%	50	
2/19/2014	$6.41	Mckeesport PA Municipal Authority	Sewer Improvements Current Refudning	/AA/	12/15/2039	4.800%	102	Insured by BAM & Bank Qualified

Source: Bloomberg

February 2014 Selected Bond Issues								
Water/Utility Sector								
3/11/2014	$6.81	Fullerton CA	Water Revenue Refunding Bonds	/AAA/	9/1/2033	3.690%	33	
3/20/2014	$40.59	Oakland CA	Sewer Revenue Bonds Current Refunding	/AA/AA	6/15/2029	3.520%	50	
Healthcare Sector								
Date	**Par ($ mil)**	**Issuer**	**Project**	**Ratings**	**Final Maturity**	**Yield**	**Spread to MMD**	**Notes**
2/5/2014	$70.00	California Statewide Community Development Authority	Henry Mayo Newhall Memorial Hospital	A2/AA-/BBB-	10/1/2043	5.300%	145	Insured by AGM
2/5/2014	$73.03	Yuma Arizona Industrial Development Authority	Yuma Regional Medical Center Series A	/A-/	8/1/2032	4.900%	150	
2/19/2014	$23.29	Colorado State Health Facilities Authority	Mental Health Center Denver Project Series A	/BBB/	2/1/2044	5.950%	211	

Source: Bloomberg