Rockfleet financial services

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# MUNI MARKET UPDATE

March 22, 2010

**INSIDE THIS ISSUE:**



**ABOUT ROCKFLEET**

Rockfleet Financial Services, Inc., serves clients nationally through its brokerage and investment banking businesses.

The company's brokerage division offers fixed income products and services specifically designed to address the needs of institutions and high net worth and affluent individuals.

The company's investment bank division provides fixed income securities products, advisory services, and market commentary.

Click here for biographies. of Rockfeet's staff.

## THE ALLURE OF BABs

By Glenn C. Dellinger, CFA

There is a $75 billion and growing sector of the market that deserves the attention of accounts exempt from taxation.

Judging from the wide spreads on the debt, too many of these investors – particularly high net worth individuals and their IRAs - have yet to take advantage of the extra yield offered by the sector without additional credit risk.

### Federal Subsidies

As part of the economic stimulus package, in February 2009 the Federal government implemented the Build America Bonds (BAB) program in order to expand municipalities' access to capital in a time of severe credit contraction.

Under the usual rules of municipal bond issuance, municipal debt is indirectly subsidized by the federal government as interest on that debt is ***not*** subject to the investor's federal income tax. As a result, municipalities are able to float debt at a nominal rate that is lower than would otherwise be the case.

From the perspective of federal budget writers, the beauty of the system is that municipalities receive their subsidy but it comes in the form of an opportunity cost of lost tax revenues to the federal government rather than in the form of an actual line item expenditure.

The problem is that the nature of the subsidy ordinarily limits the market for such debt to taxpayers who would benefit from receiving tax-exempt interest. This cuts out pension plans, endowments, IRAs, insurers and international investors who control enormous sums of potentially available funds.

Under the BAB program municipalities issue debt whose interest is taxable ***if*** the recipient is a tax-paying entity.

The municipality receives a direct subsidy instead which is equal to 35% of the interest expense.

So long as the bonds are outstanding and the borrower continues to file the proper paperwork, the borrower receives the subsidy on a contractual basis, provided that the borrower is not delinquent on payments to the Federal government for other pro-

(continued on page 2)

## ROCKFLEET IN THE NEWS

### Rockfleet Announces Opening of NYC Office

Rockfleet recently announced the opening of its midtown Manhattan headquarters office, and recent hires in its municipal securities division. The press release can be read here.

### All Hands on Deck

Catherine Corrigan, President & CEO, and Michael Keane, Chief Operating Officer, recently discussed Rockfleet's business strategy with The Bond Buyer. Read "It's All Hands on Deck as Rockfleet Makes Its Muni Broker-Dealer Debut."

## THE ALLURE OF BABs (CONT'D)

grams. (More on this later.)

**Issuer Benefits**

Given the current shapes of the taxable and tax-exempt yield curves, municipalities benefit by issuing long term debt under the BAB program while issuing shorter maturities as traditional tax exempts.

**Future Issuance of BABs**

The BAB program was currently scheduled to end at the end of this calendar year, but a bill signed by President Obama on March 18th extends the program through April 1, 2013. The subsidy would decrement annually — to 33% in 2011, 31% in 2012, and 30% in 2013.

> *It is important to note that, while the BAB program subsidizes the municipality's interest expense, the subsidy is **not** necessarily pledged toward its payment in the event of a default. The bondholder must still rely on the creditworthiness of the municipality and **not** of the federal government.*

The reduction of the subsidy applies to bonds issued after the change, not to bonds issued prior to that date.

In the near term, it is possible that BABs will cheapen as municipalities rush to market in order to take advantage of the more generous subsidy currently available, which should present an even more attractive opportunity for investors until the changes are made.

**IRS May Block Federal Interest-Cost Subsidies if the Issuer Owes the Federal Government for Other Programs**

However, a recent development with the Internal Revenue Service has, at least temporarily, put a hold on at least one state's BABs issu-

(continued on page 3)

## MUNICIPAL MARKET UPDATE

This week the municipal bond market continued to show strength thru mid-week and turned quietly softer as the week came to an end.

Retail participation has slowed considerably from the past two weeks.

The influx of smaller new issuance of local names have quietly re-priced the secondary market.

On the competitive side of the market, the $143,625m State of Wisconsin transaction sold on 3/17. It was purchased by the Citigroup account, of which Rockfleet Financial was a participant in the underwriting. The deal has been officially closed and underwritten.

By signing the new jobs bill, Washington has now extended the BABS life through 2013. Subsidy payments will be as follows: 33% in 2011, 31% in 2012, and down to 30% in 2013. This should alleviate some pressure off of issuers to rush to market by years end. (See related article, "The Allure of BABs" in this issue.)

The negotiated side of the market was highlighted by the $675 million NYC General Obligation Bonds BABS deal, which was received very well by the market place.

## VISIBLE SUPPLY

The 30-day visible supply of municipal bonds totaled $13.066 billion, up $3.853 billion from the previous session, according to The Bond Buyer.

That comprises $3.386 billion of competitive bonds, which is down $312.4 million and $9.680 billion of negotiated bonds, which is up $4.165 billion.

**Week of March 15, 2010**

Total supply: $5.9B

Taxable/BABs: $1.91B

Tax-Exempt: $4.0B

**Week of March 22, 2010**

Total supply: $10.61B

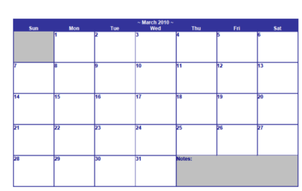
Taxable/BABs: $2.4B

Tax-Exempt: $8.21B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters. 3/12/10.

## ECONOMIC CALENDAR



## THE ALLURE OF BABs (CONT'D)

ance.and may cause the market to cheapen due to the uncertainty.

According to a March 18th Bloomberg article, the State of Florida has temporarily suspended all BABs sales, after having been recently apprised that the IRS reserves the right to block federal interest cost subsidy payments if the borrower is delinquent in payments to the Federal government with regard to other programs such as Medicaid. As a result the $255 million Florida Turnpike Authority BABs transaction, scheduled for next week, will be postponed according to Bloomberg.

### Other Issuers Proceeding as Planned

Tom Dresslar, spokesman for California Treasurer Bill Lockyer, was quoted by Bloomberg as saying that the State of California plans no changes.

(continued on page 4)

### $18 Billion Jobs Bill Impact on Private Activity Bonds (PABs)

According to a summarization of the bill's impact on BABs in The Bond Buyer, the bill also contains certain exemptions for PABs:

- All PABs issued through 2011 would be exempt from the alternative minimum tax;
- All PABs sold for water and sewer facilities would be exempted from state volume caps;
- Tribal governments would be permitted to sell PABs; and,
- The size of recovery zone bond programs would be expanded to $50 billion.

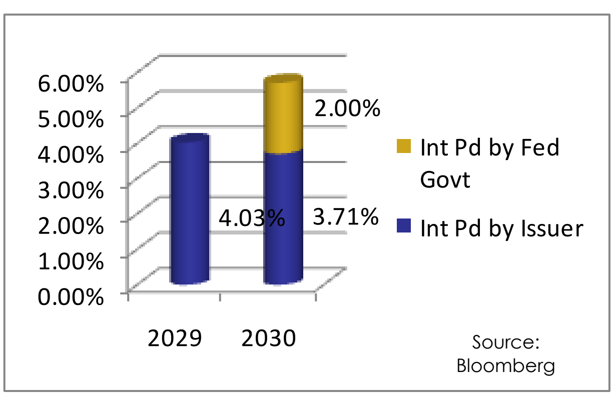
## CASE STUDY — NEW YORK STATE ENVIRONMENTAL FACILITIES CORPORATION

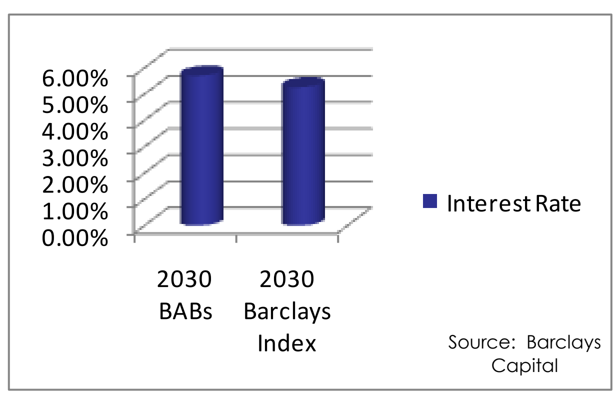
### Issuer Benefits

The savings on the long end can be seen in a New York State Environmental Facilities Corporation state clean water deal (Aa1/AA+) that recently came to market. The package included a 2029 traditional tax-exempt maturity priced to yield 4.03%. It also included a comparably secured 2030 BABs maturity priced to yield 5.707%. After the subsidy, the true cost to the agency of the BABs portion was 3.71%. The agency therefore saved itself 32 basis points in net interest expense by issuing bonds as BABs – 38 basis points if you factor in the difference between the two maturities. In a time of tight budgets, these savings certainly draw the attention of municipal borrowers.

### Investor Benefits

For the investor not subject to income taxes, the bonds also represent a substantial opportunity. Compared to the 5.71% available on the Aa1/AA+ BABs, the Barclays (formerly Lehman) AA US Corporate bond index stands at 3.77%. Adjusting for the difference in the maturities between the bonds and the index by adding 150 basis points results in a 5.27% yield for the index. So the BABs offer the investor something on the order of 44 basis points in additional yield for a comparably rated security. It should be further noted that municipal bonds have historically had a much lower default rate than comparably rated corporate bonds, so the spread pick up for comparable default risk is even more attractive.



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## THE ALLURE OF BABs (CONT'D)

The New York City $644.6 million BABs deal priced as scheduled on March 18th.

The Chicago Transit Authority has a $475 million BABs scheduled for March 22nd. To date, there is no indication that this transaction will or will not be canceled.

In a follow-up article, Bloomberg quoted Eric Johansen, debt manager for the City of Portland, as being concerned about the City's $450 million June sale of sewer system revenue bonds. Chris Lippincott, spokesman, said the Texas Department of Transportation will "continue to monitor the BABs program for use in future issuances."

It should be noted that the ability of the IRS to block the federal interest cost subsidy payments constitutes a substantial incentive for the borrower to stay current on all of its obligations.



## THIS WEEK'S CALENDAR

| Date | Amount | Issuer |
|---|---|---|
| 03/23/10 | 16,232M | Somerville, MA |
| 03/23/10 | 5,353M | East Rochester UFSD, NJ |
| 03/23/10 | 2,875M | Ipswich, MA |
| 03/23/10 | 15,325M | New Bedford, MA |
| 03/23/10 | 3,766M | Port Chester, NY |
| 03/23/10 | 15,308M | Secaucus, NJ |
| 03/23/10 | 1,145M | Wrentham, MA |
| 03/23/10 | 3,815M | Mount Kisco, NY |
| 03/23/10 | 5,900M | Southampton, NY |
| 03/23/10 | 7,500M | Watertown, CT |
| 03/23/10 | 6,925M | Abington SD, PA |
| 03/24/10 | 2,755M | Bedford, MA |
| 03/24/10 | 22,746M | Passaic County, NJ |
| 03/25/10 | 2,340M | Alden CSD, NY |
| 03/25/10 | 16,625M | Beverly, MA |
| 03/25/10 | 20,384M | Gorham, ME |
| 03/25/10 | 336,475M | State of South Carolina |
| 03/25/10 | 38,420M | Ridgewood BOE, NJ |

Click here for calendar updates.