The Municipal Market in 2017

**Volume:** We estimate total municipal bond issuance for 2017 of $365 billion will come in below 2016’s potentially record-breaking year.

- Municipal bond volume in October 2016 was $53 billion, almost a record month, but it did not beat issuance of $59 billion—a record set in December 1985 when bond sales spiked in anticipation of Tax Reform Act of 1986 limitations. This almost record-breaking month potentially sets the stage for a record-breaking year. The record, as you might recall, was set when Build America Bonds (BABs) helped propel overall issuance to $433 billion in 2010. 2016 could be a record year of about $440 billion, with November and December activity of about $25 billion per month.

- In 2017, according to our estimates, the market can expect new money issuance of about $220 billion, slightly higher than the recent average amount of new money issuance. This somewhat greater forecast for new money is a result of the plentiful number of bond-friendly ballot measures approved during the 2016 elections. We anticipate refunding issuance will be down in 2017 to $145 billion compared to 2016. We expect the interest rate environment next year will somewhat affect refunding activity. An equally important influence will be that refunding candidates are not as plentiful as in recent years.

**Infrastructure:** The proposed $1 trillion over 10 years is not likely to add to municipal bond new money in 2017 or in coming years. There would be very limited to no municipal bond issuer support for a renewed financing tool structured like the American Recovery and Reinvestment Act’s (2009) BAB program.

- President-Elect Donald Trump sees $1 trillion spent over 10 years on infrastructure, but his incentive is likely to be a revenue-neutral private sector tax credit. Therefore, not much of Mr. Trump’s current proposal is likely to be “built by bonds.”

- President-Elect Trump’s infrastructure proposal does not outright recommend a renewed BAB-type program, as did Hillary Clinton’s. But his proposal was neutral to slightly
Build America Bonds, Almost a 2009 Recovery Act Success Story

The 2009 American Recovery and Reinvestment Act created Build America Bonds (BAB) in order to broaden the U.S. municipal bond investor base. In 2009 and 2010 state and local governments, universities, transportation agencies, and utilities sold $181 billion of BABs, which are taxable bonds with a direct pay subsidy of 35% paid directly to issuers. By and large, BABs were considered a success by issuers and investors until the U.S. budget sequestration in 2013.

Why Were BABs Necessary?

The financial markets generally and the U.S. municipal bond market specifically were severely dislocated just after the September 2008 Lehman Brothers bankruptcy filing. The taxable BABs appealed to a nontraditional investor base. BABs allowed certain municipal bond issuers to access the market at levels they would not have ordinarily been able to attain considering the events surrounding the Lehman bankruptcy and 2008 financial crisis and resulting market dislocation.

Why Won’t State and Local Government Issuers Like “Renewed” BABs?

The short answer is that because each year, since 2013, the BAB subsidy the federal government pays to issuers has been reduced as a result of the 2013 sequester. The context goes back to summer 2011 when the U.S. Congress was debating the need to raise the debt ceiling. In part due to the uncertainty created by this debate, S&P downgraded their U.S. rating to AA+ (Negative). The Budget Control Act was finally signed into law on August 2, 2011, raising the debt limit and creating a super committee that was supposed to find ways to cut federal spending. If the committee failed, an automatic sequester (or across-the-board budget cuts) would take effect. The committee was not able to agree upon cuts, and the automatic enforcement procedures took effect and automatically cut spending each year from the federal budget. A portion of the BAB subsidy was one of the items cut, or sequestered every year since 2013. In an environment that is already uncertain for state and local governments and other municipal bond issuers, it is unlikely they would support the renewal of a program that was initially considered successful but now is mostly criticized.

Positive on BABs. A key problem is issuers who sold them in 2009 and 2010 have no reason to feel anything but burned (see above box for more on Build America Bonds). The BAB subsidy (direct pay to issuers of 35%) has been reduced every year since the 2013 U.S. budget sequestration; 2016 payments were reduced by 6.8%.

Threat to the tax exemption: It is very possible that the threat to the municipal bond tax exemption could rise during the Trump presidency and the 115th Congress.

- Preliminary signs such as Republican control of the executive and legislative branches of government and the potential for tax reform are enough for some to argue that the threat has increased. Add to that the negative attention the tax exemption expenditure has received from those who argue it is an inefficient incentive, and a stronger not weaker argument can be made for an increased threat. In addition, an October 2016 Congressional Research Service report recently argued in favor of tax credit bonds compared to traditional tax-exempt municipal bonds.

New fiscal reality: Credit conditions for municipal bond market issuers that have actively adjusted to the new fiscal reality remain constructive and should remain largely stable into 2017.

- Housing markets largely continued to slowly advance in 2016. Most tax bases continued to recover, and Moody’s Investors Service local government revenues as a percent of general fund median rose to a very strong 34.2%. There is no reason to think these trends could not improve again into 2017, but probably not at a pace similar to recent years.
- 2015 was the first year Moody’s public finance upgrades (555) outpaced downgrades (506).
Credit: Structural imbalances continue to plague the public finance issuers that have not reacted to the new fiscal reality. In May 2016 we wrote about the bifurcation of the state and local government bond market. Data observations since have only reinforced our thesis.

- Public finance downgrades (292) have outpaced upgrades (228) in first-half 2016, according to Moody’s. Local governments were 209 of those downgrades, and multiyear structural imbalances continue to be a key influence.
- We also noted Structural Imbalances, Budget Gaps Stressing Some U.S. State Credit Profiles in a July 2016 report.

Pensions: Some liabilities rose in 2016, and it is very possible they could continue to rise in 2017. Pension funding solutions remain elusive and politically unpalatable, especially in the most severe cases.

- “Most state and local governments have well-funded pension plans,” we wrote last year in our 2016 Outlook. While it remains mostly true, the trends for poorly funded state and local governments are worsening. Many governments still find themselves with the difficult choice of how to best allocate scarce revenues. The crowding-out impact is deepening and negatively affecting investment in infrastructure, public safety, secondary education, and higher education. The Center for Retirement Research at Boston College noted in an October 2016 report that the “governments in the worst shape face an enormous challenge.” The small amount of reforms we have seen to date still do not come close to solving the pension funding and crowding-out dilemma.

Puerto Rico: Voters in Puerto Rico elected Ricardo Antonio Rossello Nevares as their next governor. He won the election with 41% of the vote compared to the 39% David Bernier received. Mr. Rossello Nevares made the fight for statehood a key part of his campaign strategy. He argues that a new relationship with the United States is crucial to curing Puerto Rico’s economic misfortunes.

Puerto Rico related defaults continued into 2016, and the landscape suggests the potential for a long, complex debt restructuring. The U.S. government enacted the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA), signed by President Obama in June 2016. The Act provides a framework for Puerto Rico to restructure its debt and create a stay on litigation. A seven-member federal fiscal oversight board is also called for by the Act, and members were named by President Obama at the end of August. The board currently only has supervisory control but should be able to help Puerto Rico’s financial reporting and create a sustainable multiyear fiscal plan. The potential for direct federal aid in the short term is not likely.

Insurance: Mono-line insurer penetration was stable in 2016, and we expect investor and issuer acceptance to continue to remain solid into 2017.

- The four top municipal bond insurers wrapped $18.5 billion of municipal bonds through the first nine months of 2016, including Assured Guaranty Ltd. ($9.3 billion), Build American Mutual ($7.7 billion), Municipal Assurance Corporation ($745 million), and National Public Finance Guarantee Corporation ($657 million).
- A key concern about insurers is related to their exposure to Puerto Rico. Assured and National both have Puerto Rico exposure. Standard & Poor’s writes that their capital adequacy measure will remain unaffected for Assured if under their stress scenarios claim payments are 15%, 25%, 35%, and 45%. National’s capital adequacy would be affected under S&P’s 45% scenario.

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