The Economy and its Recent Impact on the Municipal Bond Market and Illinois Community Colleges’ Financing Plans

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The MMD “AAA” Index

- The Municipal Market Data (MMD) Index is a daily index of AAA-rated municipal bond rates

- Issuers’ bonds are priced relative to the MMD
  - At a “spread” to the MMD
Muni Rate Change Comparison

- In recent months municipal bond rates have risen more dramatically on the long end of the yield curve

- AAA MMD Index Change: May – October 2013
  - 1 Yr. - 0.02%
  - 5 Yr. + 0.60%
  - 10 Yr. + 0.87%
  - 15 Yr. + 1.05%
  - 20 Yr. + 1.20%
*MMD yields began increasing in early May.
Current 20-Year MMD

(1) Current Rate is the MMD 10-year rate as of 10/01/13.

(2) Data encompasses MMD 10-year rates between 01/02/90 and 10/01/13. Past performance does not guarantee future results.

Source: The Municipal Market Data “MMD” is a AAA municipal bond market index produced by TM3.
10-Year MMD vs. 10-Year Treasury
Numerous Variables Impact the Municipal Bond Market

The FED and Quantitative Easing (QE3)

Budget and Credit of the US Government

Health of national, state and local economies

Europe

Detroit

Level of federal and state income taxes

Inflation Expectations

State of Illinois Fiscal Challenges – Pension Situation

Municipal Bond Supply and Demand

Chicago’s Fiscal Challenges

Credit ratings of state and local governments

The Municipal Bond Market
The Federal Reserve (the FED)

• The purpose of the Federal Reserve is to study and set monetary policy for the United States
  – Its mandate is to promote sustainable growth, high levels of employment, stability of prices to help preserve the purchasing power of the dollar and moderate long term interest rates
    • It must foster a sound banking system and a healthy economy

• Its decisions are intensely observed and often lead the way for other countries to take the same policy changes

• The FOMC (Federal Open Market Committee) is the policy-making arm of the FED
  – They make the decisions on interest rates and other monetary policies
Federal Open Market Committee (FOMC)

• The FED constantly buys and sells U. S. Government Securities in the financial markets, which in turn influences the level of reserves in the banking system

• The FED’s goal is to influence the Federal Funds Rate (the rate at which banks borrow from one another)

• The FOMC sets a target Federal Funds Rate
Federal Open Market Committee (FOMC)

• If the target Federal Funds Rate has decreased, the FOMC buys securities

• When it buys securities, it creates money to do so, which increases the supply of reserves in the market

• It puts more money into the economy
What is QE?

• A big ship that crosses the Atlantic
• Queen Elizabeth
• Quantitative Easing
Quantitative Easing

• The FED’s term for buying bonds and other assets in order to push more money into the economy

• The FED wanted to drive up the available supply of money for loans, driving down long term interest rates so more people would buy and build homes and invest in businesses

• With short term interest rates already near zero, the FED’s traditional tool couldn’t be pushed any farther
Quantitative Easing History

**QE1**
Dec. 2008 – March 2010
- Originally $600B purchase of mortgage-backed securities (MBS) and agency debt
- Expanded in March 2009 by $750B purchases of MBS and agency debt and $300B of Treasury securities
- Weakened the US Dollar and supported equity markets

**QE2**
Nov. 2010 – June 2011
- Purchase $600B of longer dated Treasuries ($75B per month)

**Operation Twist**
- Purchase $400B of bonds in years 6 through 30 and sell bonds with maturities less than 3 years
- Extended average maturity of the FED’s portfolio
- Brought risk aversion in equity markets and strengthened the US Dollar
- Added $267B in June 2012

**QE3**
Sep 2012 - ?
- Purchase $40B of agency MBS per month until the labor market improves substantially
- Dec. 2012 – FOMC added monthly purchase of $45B of long term Treasury securities
What Will the FED Do With QE3?

- In May 2013, Fed Chairman Ben Bernanke stated that the FOMC might taper QE3 in the near future.

- In June he stated that he expected to start withdrawing stimulus this year and end asset purchases by mid-2014, when the jobless rate was likely to be near 7 percent.

- The July 30th FOMC meeting minutes showed that some members supported tapering the program, while others urged patience.

- On September 18th, Chairman Bernanke emphasized he had no fixed calendar in mind for tapering and that the FOMC would need more data to drive its future policy decisions.
  - More evidence of solid growth.
Some of the Key Economic Variables

• Initial jobless claims were generally positive in July and August

• The 2\textsuperscript{nd} quarter GDP report released on August 29\textsuperscript{th} was more favorable than expected (2.5% increase vs. 2.2% surveyed)

• The August Manufacturing ISM report was also positive, beating expectations (released on September 3\textsuperscript{rd})

• As reported on September 6\textsuperscript{th}, payrolls rose less than forecast. Unemployment was lower but mostly due to fewer people seeking jobs

• September employment report showed a gain of 166,000 jobs (less than the 180,000 expected)
  – August results were also adjusted downward
Government Shutdown

• Negatively impacts the economy and extends the need for continued stimulus

• Hopefully, its impact on the municipal bond market will be limited
  – Depends on duration, impact on incomes, consumer spending, etc.
  – The Fed may delay tapering of QE3 even longer, keeping medium to long term rates steady or perhaps moving them lower

• Federal government-produced economic data will not be released
  – FOMC won’t receive reports that drive their decisions

• Impact of political uncertainty
  – Sequestration, Part II
  – Debt Ceiling
Municipal Bond Supply and Demand

• The municipal bond market is approximately $3.72 trillion
  – Nearly half of it is owned by individual investors, though at the lowest levels since 2007

• Supply and demand for new municipal bonds is low
  – Municipal bond funds have reported record outflows
    • Nearly $45 billion for 19 straight weeks through October 2\textsuperscript{nd}
    – Greater localized demand for highly rated credits

• Investors want to limit their exposure to volatility in municipal bonds
  – Inflates the cost of borrowing for issuers

• Issuers throughout the country have issued $224 billion of debt so far this year, the lowest in two years
  – Fewer refundings

• The 30-day forward calendar is very low
Detroit

• The City of Detroit filed for bankruptcy on July 18, 2013

• Problems center around its underfunded pension system, and it also includes paying bondholders a fraction of its debt service payments
  – Impacts general obligation (G.O.) bonds

• So far its impact has been limited to some local issuers within the State of Michigan

• Unprecedented and complicated litigation will not be resolved for several months
  – If the courts determine that Detroit doesn’t have to pay its bondholders in full, it could have a disastrous impact on issuers throughout the country
  – Has the potential to redefine the meaning of a general obligation bond
Credit Spreads

MMD Bond Index By Rating Category

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The State of Illinois

- Illinois now has the lowest credit rating of any state in the country

- The pension crisis has yet to be addressed, which is directly impacting local issuers in Illinois

- Some investors will no longer buy bonds from any issuer in Illinois

- The City of Chicago’s unfunded pension liability and deficit budgets also caused a “triple notch” Moody’s downgrade on its general obligation bonds to A3
The “Illinois Penalty” Continues to Impact Illinois Community Colleges

Illinois vs. Non-Illinois Spread (Bank Qualified "AA" Credit)

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