

Long-term Local Government Borrowing: The Fundamentals of Municipal Bonds

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Legal Mechanisms for Long-term Borrowing

General Obligation

Requires voter approval

Unlimited full, faith and credit tax-backing

Not subject to annual appropriation

Revenue Bonds

Security is dependent upon the strength of pledged payments from a particular enterprise

Intergovernmental Contract

Contract between local government and an Authority with the legal ability to construct a particular project

Limited to statutory M&O taxing limits (i.e. 20-mill, limit for school districts)

Not subject to annual appropriation

Lease

Subject to annual appropriation

Limited to statutory M&O taxing limits

Total amounts limited to 7.5% of prior years local tax receipts (Sales tax issues)

Bond Pricing

Every bond has three characteristics: coupon, yield and price.

Coupon – The stated rate on the bond

A \$100,000 maturity with a 5% coupon will pay \$5,000 a year in interest.

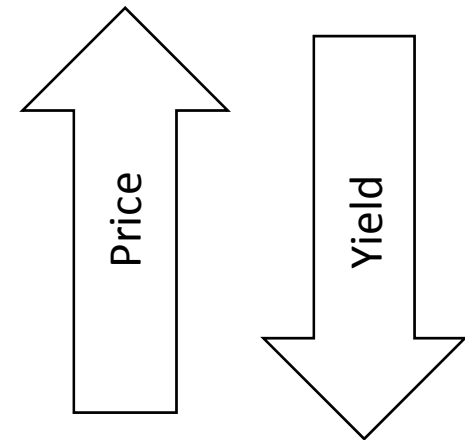
Yield – Indicates the total cost to the issuer of the bonds.

The key for investors and issuers.

Price – The amount paid by the investors for the bonds.

Price and Yield have an inverse relationship.

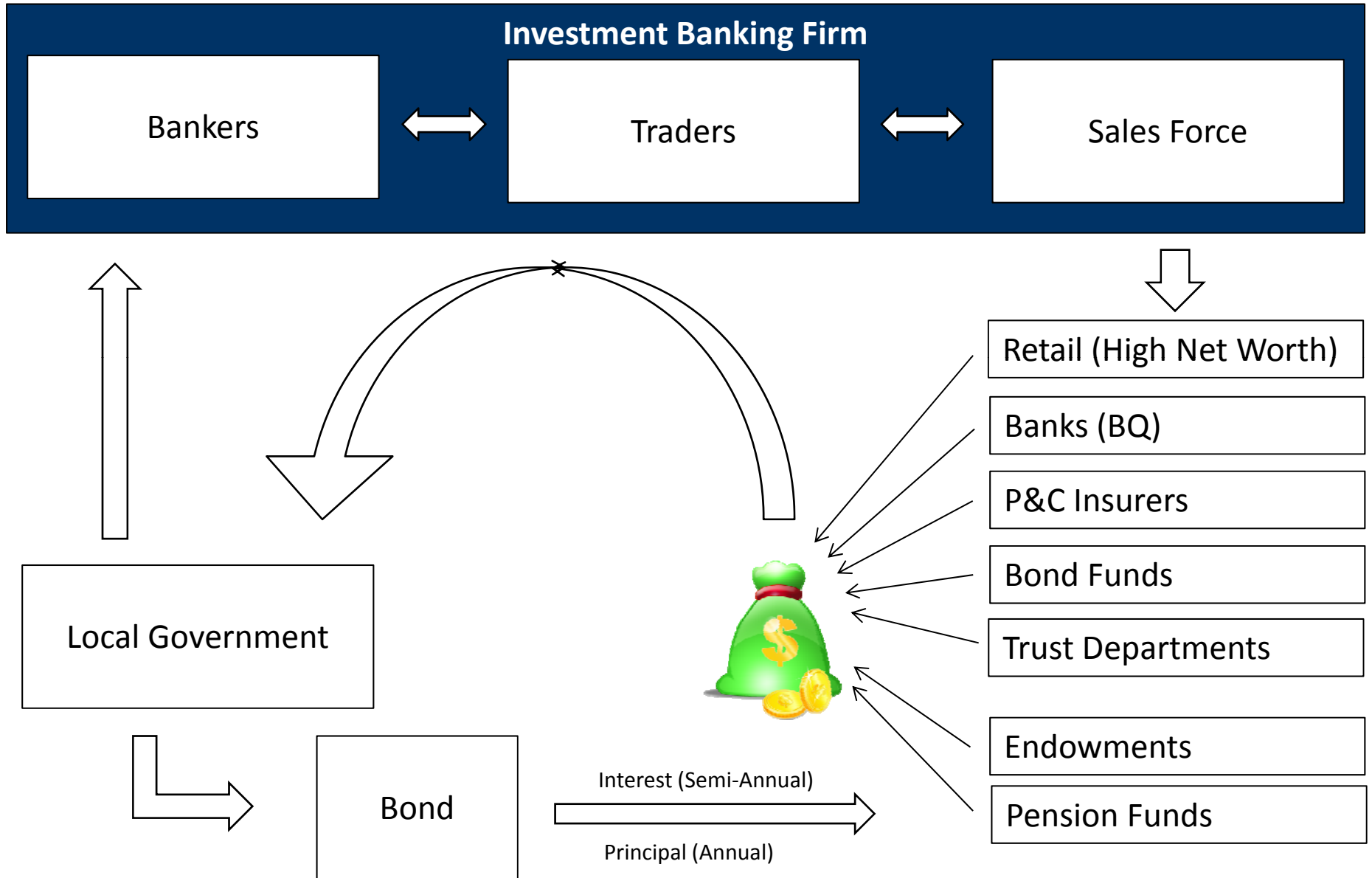
If an investor pays a higher price for a set stream of cash flows the yield (return on investment) will be less.



Bond Pricing

	Par		Premium		Discount	
Total Par	100,000		98,106		101,968	
Coupon	5.00%		5.25%		4.75%	
Yield	5.00%		5.00%		5.00%	
Price	\$100.00		\$101.93		\$98.07	
Proceeds	\$100,000		\$100,000		\$100,000	
Year	Payments	PV Payments	Payments	PV Payments	Payments	PV Payments
1	5,000	4,762	5,151	4,905	4,843	4,613
2	5,000	4,535	5,151	4,672	4,843	4,393
3	5,000	4,319	5,151	4,449	4,843	4,184
4	5,000	4,114	5,151	4,237	4,843	3,985
5	5,000	3,918	5,151	4,036	4,843	3,795
6	5,000	3,731	5,151	3,843	4,843	3,614
7	5,000	3,553	5,151	3,660	4,843	3,442
8	5,000	3,384	5,151	3,486	4,843	3,278
9	5,000	3,223	5,151	3,320	4,843	3,122
10	105,000	64,461	103,257	63,391	106,811	65,573
	150,000	100,000	149,612	100,000	150,403	100,000

Where do investment bankers sell the bonds?



Marketing of Bonds

Premium or Discount

Ratings

Liquidity

Call Features

Municipal Bond Insurance

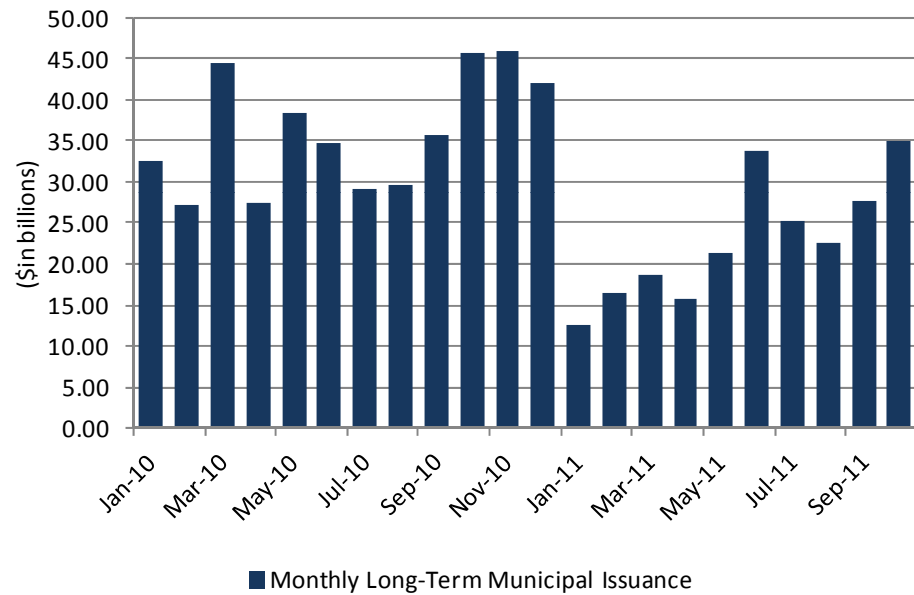
Debt Service Reserve

Serial Bonds and/or Term Bonds

Municipal Long-Term Issuance

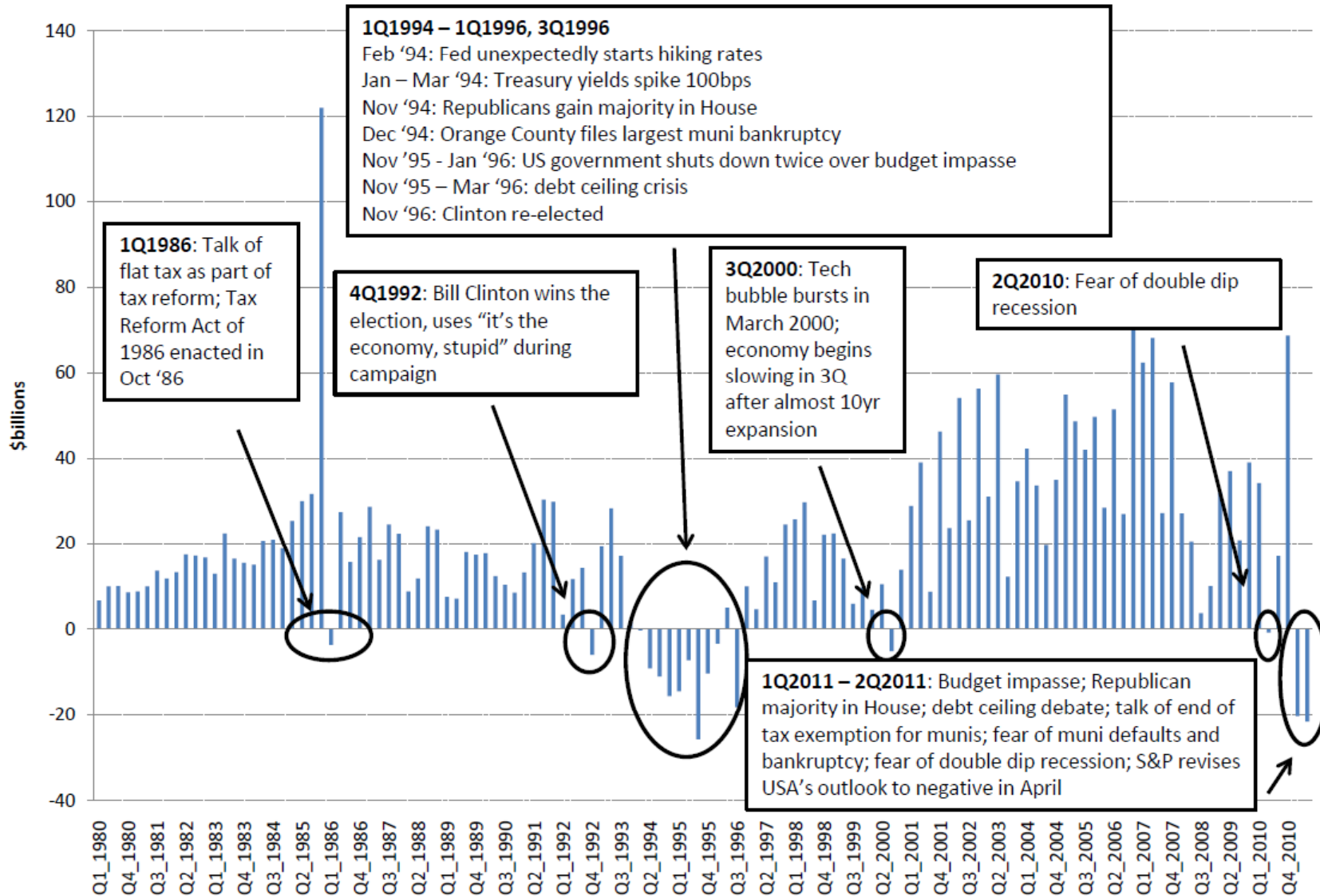
- As of the end of October, Long-term municipal new issue volume is down 33.7% since the start of 2011.

Municipal Long-Term Issuance			
\$ in billions	2010	2011	YoY %
January	\$32.660	\$12.494	-62%
February	27.187	16.478	-39%
March	44.561	18.691	-58%
April	27.498	15.676	-43%
May	38.324	21.286	-44%
June	34.682	33.772	-3%
July	29.152	25.186	-14%
August	29.708	22.585	-24%
September	35.695	27.745	-22%
October	45.667	34.976	-23%
November	46.045		
December	42.037		
Total	\$433.216	\$228.888	



Source: The Bond Buyer

Quarter-to-Quarter Change in Muni Debt Outstanding



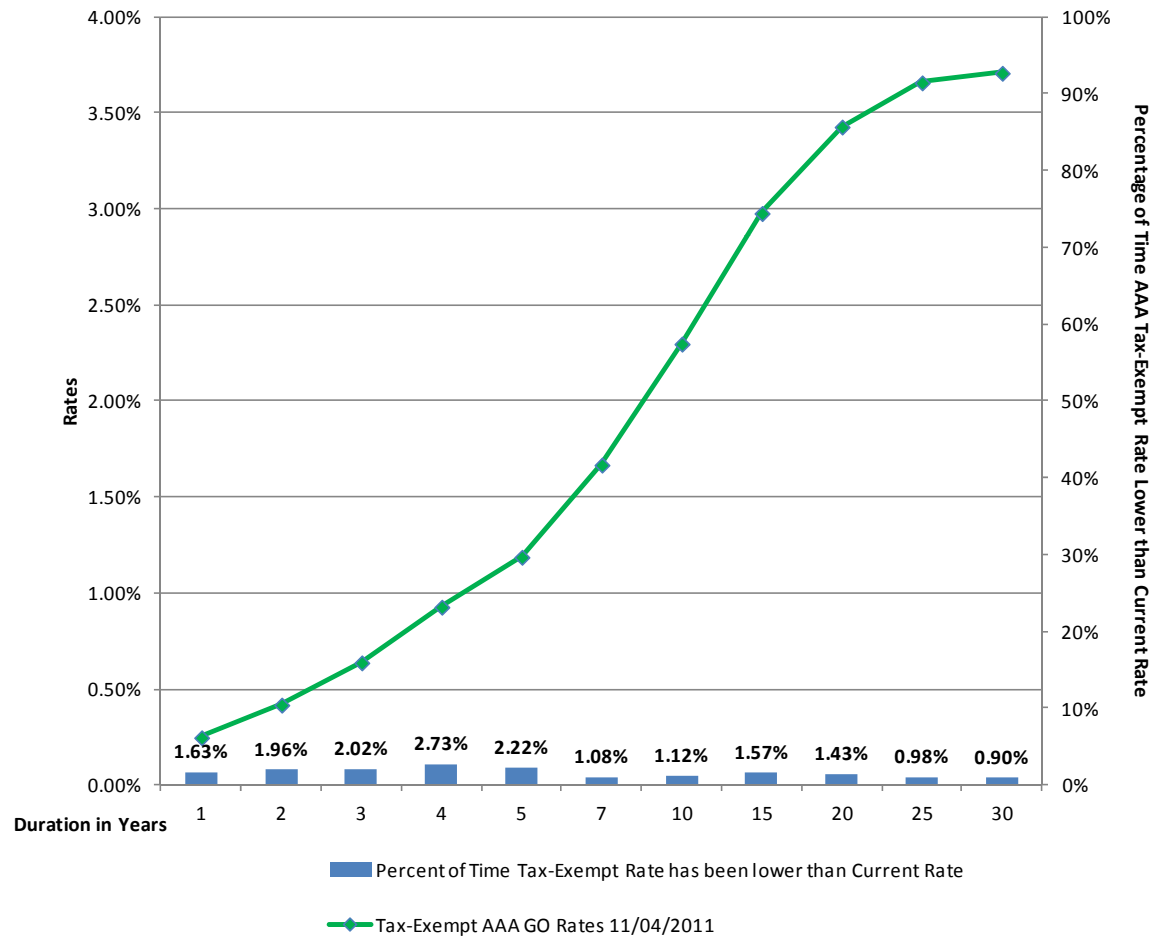
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Source: Federal Reserve, Morgan Keegan

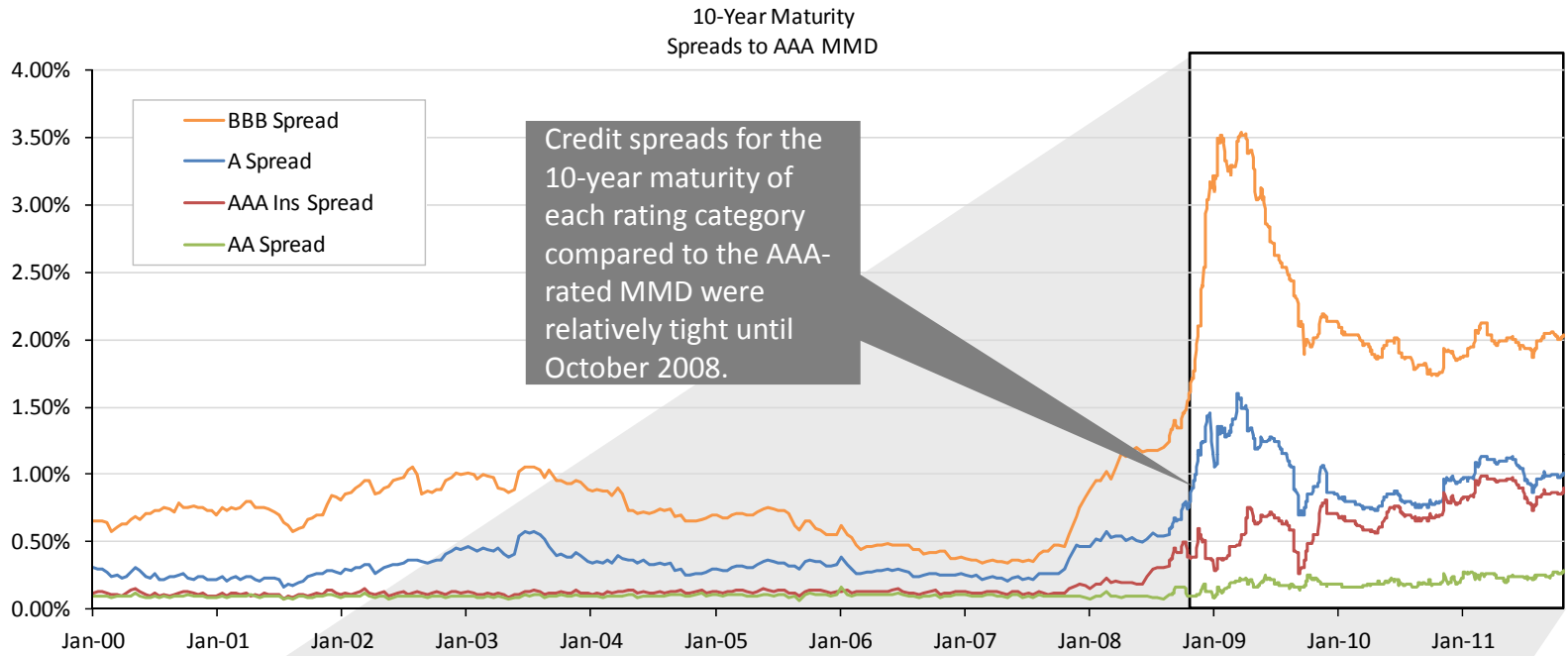
Morgan Keegan

Rate History

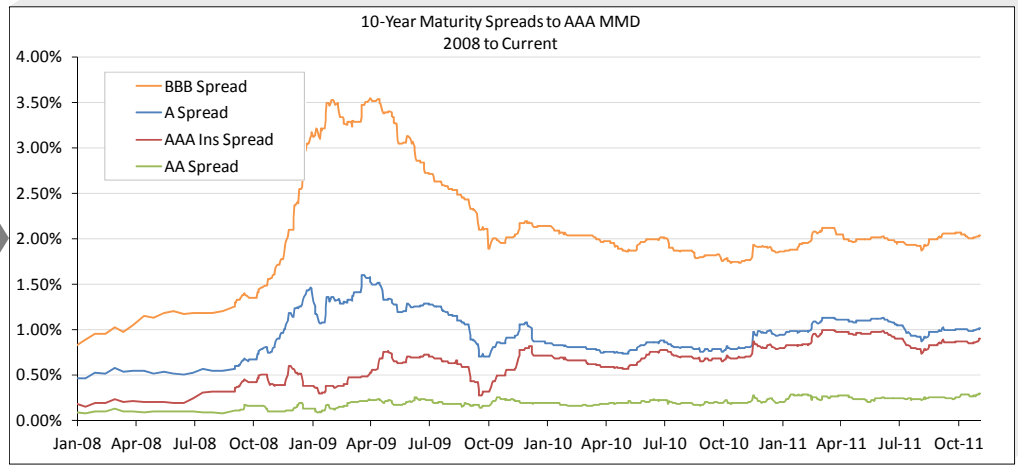
- Despite the relative steepness of the AAA MMD yield curve, absolute yields remain near all-time low levels.
- The graph below details the current MMD levels and the percentage of the time rates have been lower than today since 1993.



Historical Credit Spreads to AAA MMD



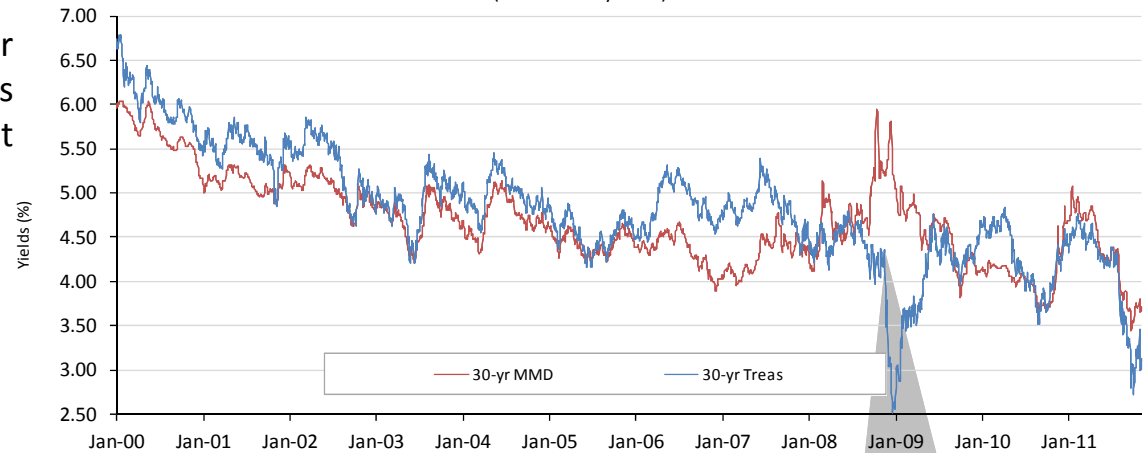
At the start of the credit crisis in October 2008, spreads began to rise well above the AAA MMD, reflecting concerns with underlying credit quality.



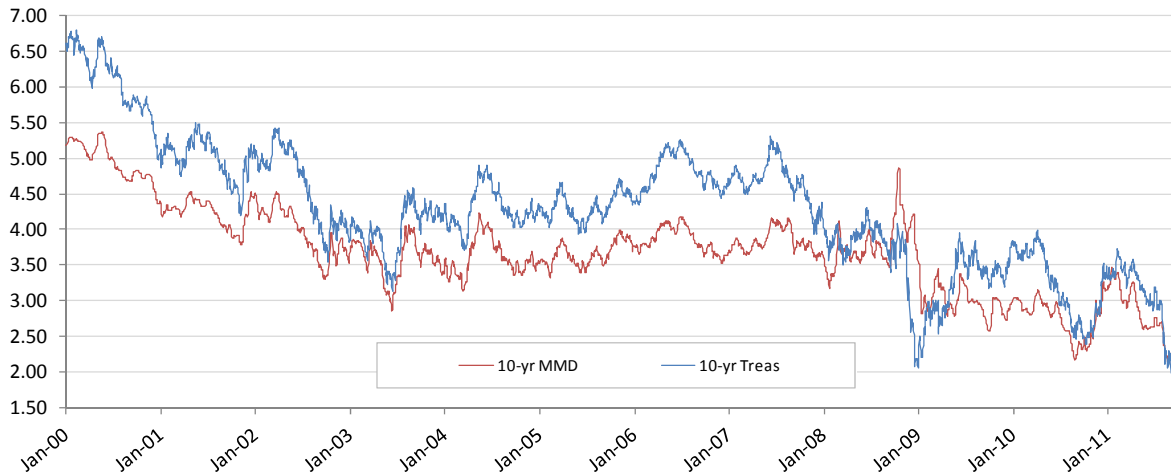
Relationship of AAA MMD to Treasuries

The spread relationship between the 10-Year and 30-Year taxable and tax-exempt curves has been relatively consistent until the recent turmoil in the financial markets.

30-Year AAA MMD vs. 30-Year Treasury
(Since January 2000)



10-Year AAA MMD vs. 10-Year Treasury
(Since January 2000)

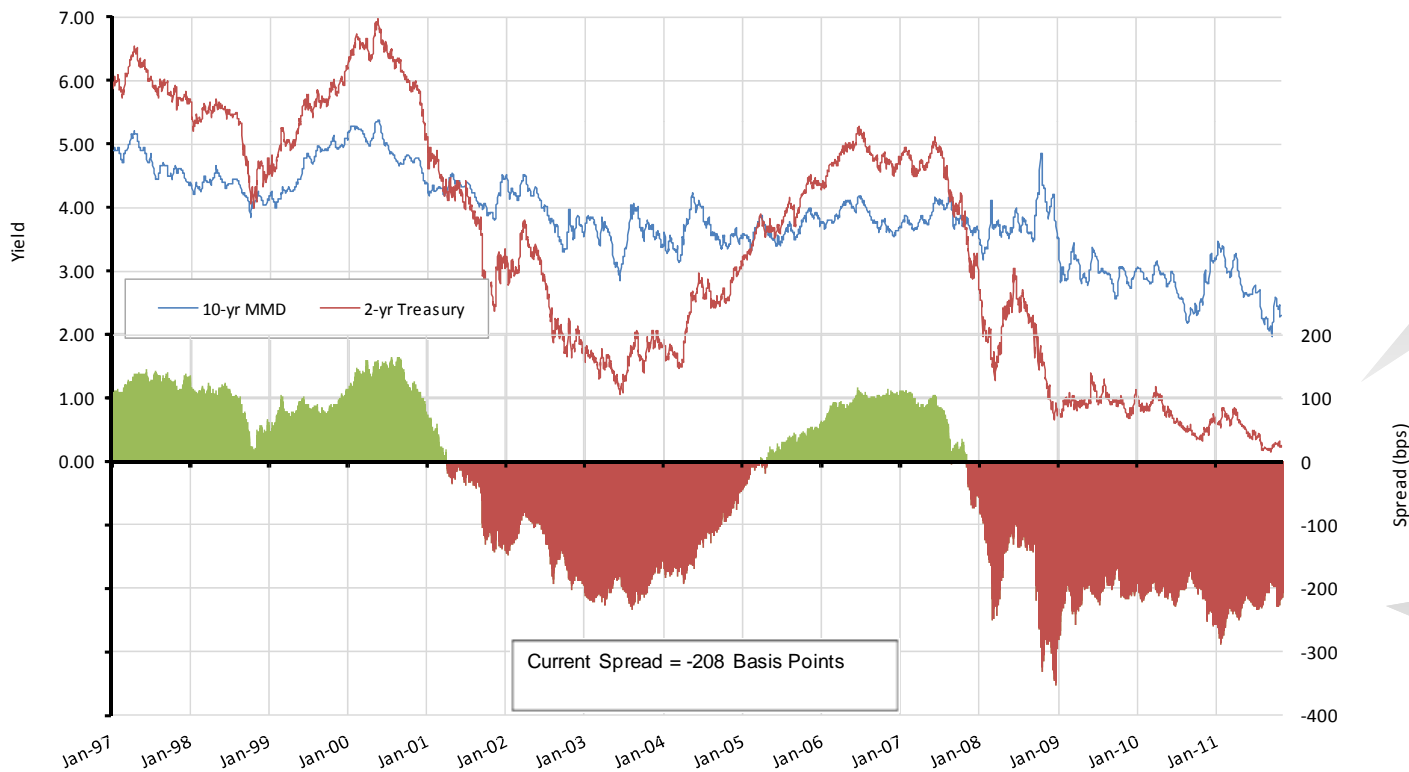


In late 2008, ratios inverted as investors preferred to purchase U.S. Treasuries. The ratios are trending back to historical levels indicating that investors are seeking investments with higher yields than Treasuries.

Negative Arbitrage: Recent Changes between AAA MMD and Treasuries

- State and Local Government Securities, or SLGS, are special Treasury securities sold by the United States Treasury Department to states, municipalities, and other local government bodies. SLGS are most commonly used as investments in an escrow account in connection with the issuance of refunding bonds. SLGS yields are derived from Treasuries.
- Negative arbitrage is the difference between the actual investment earnings in the escrow (the yield on the SLGS) and the investment earnings that can legally be earned in the escrow (the arbitrage yield on the refunding bonds).

10-Year AAA MMD vs. 2-Year Treasury



- The 10-yr MMD is used as a proxy for refunding bonds and the 2-yr Treasury is used as a proxy for escrow accounts.

Negative arbitrage continues to be a problem as spreads between short-term treasury yields and AAA MMD yields remain relatively wide.

Red represents periods of negative arbitrage while green represents times of favorable arbitrage.

Rate Forecast

- Both the Morgan Keegan economist (Dr. Donald Ratajczak) and the Bloomberg consensus of economists predict that rates will rise over the next year and a half.

Morgan Keegan Economist

US Treasury	Current Rate	2011		2012			2013	Increase from current to 2011 Q1	
		4Q	1Q	2Q	3Q	4Q	1Q		
2 Year	0.28%	0.29%	0.36%	0.43%	0.54%	0.62%	0.75%	0.90%	0.62%
10 Year	2.43%	2.32%	2.46%	2.65%	2.81%	3.05%	3.28%	3.42%	0.85%
30 Year	3.70%	3.40%	3.53%	3.69%	3.84%	4.07%	4.29%	4.42%	0.59%

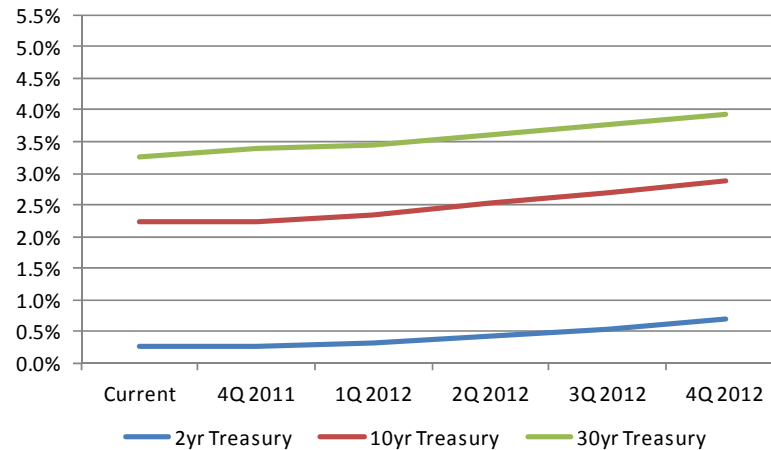
*As of November 1, 2011

Bloomberg Consensus

US Treasury	Current Rate	2011		2012			2013	Increase from current to 2013 Q1
		4Q	1Q	2Q	3Q	4Q	1Q	
2 Year	0.28%	0.28%	0.33%	0.43%	0.54%	0.69%	0.80%	0.52%
Economists Surveyed	-	60	60	60	59	54	0	
10 Year	2.23%	2.23%	2.34%	2.52%	2.69%	2.88%	2.97%	0.74%
Economists Surveyed	-	77	77	76	75	70	0	
30 Year	3.26%	3.38%	3.46%	3.61%	3.78%	3.94%	4.09%	0.83%
Economists Surveyed	-	58	58	58	57	52	0	

*Source: Bloomberg as of November 7, 2011

Bloomberg Consensus Projections



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