Public Sector Advisors

Springsted
Economic Review and Forecast

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October 17, 2014

PRESENTATION TO
Kansas Government Finance Officers Association 2014 Fall Conference
Executive Summary – The Good

• **United States Economy Continues improving**
  – Economic production statistics showing upward trend
  – Unemployment gradually improving

• **Housing is improving, but market is “thin”**
  – Home prices increasing in most markets
  – Mortgage rates rising
  – New construction improving
  – Foreclosures declining as projected

• **Interest rates likely to remain low through 2015**
Executive Summary – The Not So Good

• Pace of US Recovery remains frustratingly slow
  – Affects labor force participation
  – Barriers to new graduates

• Europe remains in difficult circumstances

• US Housing improving, but not robust growth
  – House prices rising, but demand remains less than robust
  – Existing housing stock doesn’t match future housing demand

• Demographics presents continuing challenges

• Consumer debt increasing
Economic & Financial Connections – Pt I

- **Straight line connections**
- **Multi-point matrix**
- **James Burke**
  
  “The entire gestalt of the modern world is the result of a web of interconnected events, each one consisting of a person or group acting for reasons of their own (e.g., profit, curiosity, religious) motivations with no concept of the final, modern result of what either their or their contemporaries' actions finally led to. The interplay of the results of these isolated events is what drives history and innovation.”
Economic & Financial Connections - Pt II

- **Iterative relation between**
  - Politics
    - Reward or Deprivation
  - Economics
    - Stimulus or Austerity
  - Nations
    - Imports or Exports

- **Other Factors**
  - Demographics
  - Resources
Changing Political Environment

- 2014 and 2016 Elections reduce likelihood of major legislation
  - Tax Reform delayed
  - Entitlement Reform delayed
  - Health Care Challenges
- State and Local Gov’t
  - Fill leadership void
  - Implement fed mandates
  - Tax Changes
Topics Considered – October 17, 2014

• Review of 2014 Q’s 1-3 and preview of Q4
  – Economics
    • Housing
    • Inflation
    • Unemployment
  – Interest Rates – US Treasury & Public Finance

• Predictions for 2015
  – What changes are in store?
Recent Market Changes - Public Finance

• **How has “the public finance market” changed?**
  – Demand for tax exempt bonds has rebounded
  – Months of cash inflows into Municipal Bond Mutual Funds through mid-October 2014
  – Higher yields compared to Treasuries
  – Buyers not concerned about rates rising in the future

• **Bank purchases**
  – Increasing market share
  – Opportunities & challenges
    • Municipal debt as qualifying Highly Liquid securities
    • Basel III implementation
Political Challenges

- **Debt Ceiling**
  - Decision to be made again in early 2015

- **Sequestration**
  - 2015 continued budget cuts
  - 2015 Sequestration % up

- **Health Care Reform**
  - Implementation/expansion
  - Medical Device Tax repeal?
Kansas Public Finance Market - 2014

• **Rise in Interest Rates**
  – Jump in 2\textsuperscript{nd} Quarter
  – Rates declined from August to date on economic news

• **Continued Demand for Strong & Weak Credits**
  – Oversubscription on competitive and negotiated sales
  – Strong demand for long 25-30+ year maturities even on low rated issues

• **Low Supply Continues**
  – Results from less new money issuance
  – Rising rates reduced refunding opportunities
  – Competition from Bank Private Placements
Public Finance Market General – 4Q 2014

• Continuation of low interest rates
  – US Treasuries rates plunged in mid-October
  – FOMC pledge to keep rates low through “mid-2015”
  – Volatility in prices from week to week

• Uncertainty about 2014 Election & 2015 1Q Debt Ceiling
  – Uncertainty is bane of bondholders

• Limited supply of bonds helps keep public finance rates low, but high relative to US Treasury rates

• Municipal Bond Fund Inflows continue, keeping downward pressure on rates
Interest Rate Forecast

• FOMC – No Increase until mid-2015 – and they mean it!
  – Chair Yellen favors stimulus until economy improves

• If I can’t be on Bloomberg’s rate projection group, I have a statute in Philadelphia

• Increasing likelihood of low rates
  – Fall 2015 rate rise expectation gaining ground
Long Term Challenges Not All Financial

- **Demographics**
  - Social and Economic Challenges and Opportunities

- **Baby Boomers**
  - 8,000 to 10,000 a day turn 65
  - Moving out of work force

- **Millennials**
  - Profoundly affected by “Great Recession”
  - Only 26% believe they will be better off than their parents
  - Less than 20% believe other people can be trusted (40% boomers)
  - Meaningful employment delayed
  - Will be improved as Boomers retire in force
## Inflation of Selected Assets / Services

<table>
<thead>
<tr>
<th>Component</th>
<th>1985</th>
<th>2013</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>College tuition and fees</td>
<td>100.00</td>
<td>537.60</td>
<td>537.60%</td>
</tr>
<tr>
<td>Medical Care</td>
<td>100.00</td>
<td>285.56</td>
<td>285.56%</td>
</tr>
<tr>
<td>Consumer Price Index</td>
<td>100.00</td>
<td>146.67</td>
<td>146.67%</td>
</tr>
<tr>
<td>Shelter</td>
<td>100.00</td>
<td>218.93</td>
<td>218.93%</td>
</tr>
<tr>
<td>Gasoline</td>
<td>100.00</td>
<td>120.74</td>
<td>120.74%</td>
</tr>
</tbody>
</table>

**Sources:** Bloomberg, US Census, US Bureau of Statistics
US Treasury Rate Change Sept – Oct 2014

- **Dramatic Reduction in Past Month**

<table>
<thead>
<tr>
<th>2014 US T Mkt</th>
<th>8-Sep</th>
<th>19-Sep</th>
<th>14-Oct</th>
<th>15-Oct</th>
</tr>
</thead>
<tbody>
<tr>
<td>US 30-Year</td>
<td>3.23%</td>
<td>3.30%</td>
<td>2.95%</td>
<td>2.80%</td>
</tr>
<tr>
<td>US 10-year</td>
<td>2.47%</td>
<td>2.59%</td>
<td>2.20%</td>
<td>2.00%</td>
</tr>
<tr>
<td>US 2-Year</td>
<td>0.53%</td>
<td>0.57%</td>
<td>0.37%</td>
<td>0.27%</td>
</tr>
<tr>
<td>US 3-MO LIBOR</td>
<td>0.23%</td>
<td>0.23%</td>
<td>0.23%</td>
<td>0.23%</td>
</tr>
</tbody>
</table>

Source: Bloomberg
Economic Activity & Statistics - 2014

• **2014 US Growth Rate is approximately 2% annualized**
  – Below long-term trend of 3% +/- Annual growth

• **Labor Productivity Growth has slowed to 1% per year**
  – Lower than in past and too low to accelerate US economic growth

• **Consumer spending accounts for 65 – 70% of GDP**
  – Future spending pattern changes due to demographic changes
  – Slow growth reduces household formation, durable goods purchases
  – Millennials future expectation of prosperity

• **Deleveraging of consumer debt continues**
  – May take to late 2015 to 2016 before deleverage is complete
Economic Activity & Statistics up to 2014

- All Consumer Credit debt rose $127 billion to $11.28 trillion – largest rise since 1Q 2008
- Increase in Auto Loans, Mortgages, Student Loans
- Remains below $12.68 trillion in 3Q 2008
- Credit card debt declined to $885 billion from $1 trillion in 2008 – but Student loan debt rose to over $1.3 trillion
Legal Environment Changes – 2014+

• Legal structure of Public Finance Industry
  – SEC / MSRB changes
  – Municipal Advisor designation / rules

• Underwriter & Bond Counsel Due Diligence Inquiries
  – Bond disclosure documentation & review
  – MCDC initiative by SEC

• Bank (Basel III) rules
  – Bank Capital requirements
  – Will reduce availability of bank Letters of Credit & increase cost
  – Definition of Liquid Assets – excludes most muni bonds
US Economy Improving

• Unemployment Declining
  – 5.9%, Sept. ‘14; 7.3%, Sept. ‘13, 7.8% Sept. ‘12; 9.0% Sept. ‘11; 10.0% Oct. ‘09

• Workforce Participation Rates
  – 62% in Sept 2014, close to a 30-year low (avg. 66% ‘03 – ’09)
  – Women’s participation reached a plateau
  – Over 55 age growing at 3X rate of adult population as a whole
  – People over 55 are ½ as likely to be in workforce as age 25-54

• Workforce Growth
  – 1950 – 2000 – average annual workforce growth of 2.5%+
  – 2001 – 2012 – average annual workforce growth of 1%
US Economy Improving - Housing

• Property values rose 12% year over year thru September
  – Highest year to year gain since July 2010
• Virtually all Metro Areas show price increases in 2014
• Foreclosures slowing dramatically
• Fitch – some markets (CA, FL, NV) Housing prices rising at unsustainable levels
• Avg. 30-year mortgage loan rates are low, but up for year
  – 4.10% in early November 2014
  – 3.35% in May 2013 – lowest rate since 1972
But – Housing has issues

- **Institutional & Non-Traditional Buyers**
  - Institutional buyers who expect to rent out homes are increasing their share of home purchases
  - Investment partnerships

- **Homeowners are constrained**
  - Fewer Homeowners “under water” on mortgages
    - Over 2.5 million homes equity became positive due to rising prices
    - Negative Equity Limits ability to refinance & relocate
    - Over $1 Trillion of mortgage debt has been written off by lenders

- **Mortgage Applications decline since May**
  - Inventory rising in response to price increases, but demand is slowing
US Government Response to Challenges

• **Keep interest rates low**
  – 0-.25% through “Mid 2015” extends time Federal Reserve expects to keep rates low
  – Multiple voting FOMC members now concerned about Global growth
  – Possibility of low rates for more than 12 more months rising

• **Bond Purchase Programs**
  – QE 3 – purchase of Mortgage bonds, US Treasury debt
  – Continued program through 2013, then reduced gradually, exit from market by November 2014
Finance Market Recalibration Update

• Relationship between US Treasury and Tax-Exempt
  • Tax-Exempt trade at (in theory):
    – US Treasury rate \( \times (1\text{-marginal tax rate}) \)

• Market Since 2010
  • Tax-Exempt traded at 100% or higher of equiv US Treas
  • Deviation declining but remains volatile

• Outcome
  • Government policy and poor economic conditions in Europe have kept US Treas rates low
  • Reversion to mean – projected for 2010, but has not begun
  • Short term rates remain in narrow band
Inflation Environment – Rate Projections

- **Inflation remains very low**
  - TIPS Funds lost 5.9% in 2013, Like amount in 2014

- **Little inflation pressure**
  - Unemployment remains higher than expected
  - Many new jobs are in service industry, lower wage rates

- **Deflation increasing again as a concern in US**

- **Investor diminishing expectations of rate increases**

- **Banks switching investment security classification to “held-to-maturity” rather than “available for sale”**
The Current & Future Economic World

• **European challenges**
  – Europe overall is in recession
  – Greek economy continues to shrink
  – Spain, Italy, Portugal, Ireland all have liquidity & finance issues
  – UK considers leaving the European Union (again)

• **Brazil, Russia India, China (BRIC) challenges**
  – Economies of BRIC countries are slowing
  – Demand for US Products lower
  – Economic corruption in some countries delays economic growth
  – BRIC population growth requires continued economic growth to maintain/improve living conditions for citizens
Rating Agency Public Finance Updates

- **Moody’s**
  - Methodology revision in 2014
- **Standard and Poor’s**
  - Methodology revised 2013
- **Fitch, Kroll, DBRS, others**
  - Increasing influence
- **Primary Effects?**
  - Factor weighting
  - Qualitative vs. Quantitative
  - Normalized data
    - Enhance Comparisons
Rating Agency & Continuing Disclosure

• Rating Agency changes
  – Adjustment to Government reported Pension data
    • Adjustments increased unfunded pension liability
    • Unfunded amount goes to $2.2 trillion from $766 billion
    • Annual funding required to “make whole” estimate rises to over $100 billion

• Continuing Disclosure to become more important
  – Disclosure will be required to be made more quickly
    • Move toward corporate type disclosure – 90 or fewer days from FYE
  – Disclosure will be required to be made more frequently
    • Initial focus will be on revenue issues
    • Health care currently subject to quarterly filings
  – More costly to comply with disclosure rules
Rating Agency Update – Practical Results

• Investors Expand Non-Rating Agency Data Reliance
  – More independent analysis
  – Internal @ Mutual Funds

• More Frequent Data Disclosure Request/Demand
  – Quarterly
  – Periodic calls from major investors – Entity Response?

• Cost Effect
  – Additional Staff, monitoring & distributing information, legal issues

• Other Possible Outcomes
  – Difference between CAFR & Rating Agency figures & calculations
Market Changes

• **Bond Insurance use increasing**
  – Over 5% of governmental debt insured in 2014
    • Well below 50% use prior to 2008
  – Limited market participants now
  – Insurance firms very selective in what type of Credit to insure
  – Examples include
    • Detroit
    • Puerto Rico

• **Public Private Partnerships**
  – Increasing use and popularity
  – Strong demand from Pension funds, Overseas firms
Forecast 2015

• Capital improvements delayed since 2008 likely to begin
  – Road improvements/repairs
  – Building deferred maintenance addressed

• New projects continue to meet political resistance
  – Voters continue to resist new projects

• Refunding of outstanding debt continues at slower pace

• Inflation remains subdued

• Interest rates – Treasury and Muni – remain low, but likely to rise modestly and steepen yield curve

• Investors continue to search for yield
Forecast 2015

• **Oil Prices decline further, then stabilize**
  – Per Barrel price has declined from $110 to $85
  – Increasing supply US and worldwide
  – US Oil imports fallen by 8.7 million barrels/day since 2007
  – OPEC pledges to maintain production levels, accept lower prices
  – Political effect on other Countries
  – Economic effect on other Countries

• **Gasoline prices decline as Oil Prices decline**
  – Per Gallon price decline of over 205 since late June
  – 1 cent decline in gas price = $1 billion decline in energy spending
Forecast 2015

• **Dollar remains strong vs. Other Currencies**
  – Increases US purchases of foreign goods
  – Worsen balance of Trade by reducing exports
  – Strengthens US $ as Currency of Choice

• **Positive and Negative Effects**
  – Helps foreign Countries economic growth, increasing exports
  – Reduces deflation risk in foreign Countries
  – Hurts US exporters, reducing US economic growth rate
  – Pressure on Oil Exporting Countries (Russia, Venezuela)
Forecast 2015

• Public Private Partnerships Expand
  – Private capital plentiful
  – Foreign demand for long-term infrastructure projects is strong
  – Employment improves during construction and after completion
  – Legal and financing challenges

• Governments recover financially, but...
  – Property value increases boost real estate tax revenue
  – Sales increases boost sales and use tax revenue
  – Government employment grows, but remains 482K below 2008
  – Underfunded pension liability
  – OPEB issues
Forecast 2015

- Tax Reform Gains Traction – but stalled until 2017
  - Tax Exemption may be reduced by tax reform legislation
    - Limitation on Tax Exemption possible
    - Which itemized deductions to limit?
- Demographics increase their influence on economy
  - Aging population
  - Work Force Participation
  - Cost of seniors
    - Medical
    - Infrastructure
Your Questions, Comments & Thoughts?
Thanks for your attendance, participation and attention.

Our view of the economic outlook remains that there is more positive than negative moving forward. We expect the next few months to be difficult as the economy confronts external events including military conflict, Ebola issues and Congress continues to consider deficit reduction measures.

Contact Springsted staff for additional information or follow-up on questions from today’s Symposium.

For economic questions, contact me at: Barry W. Fick
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Information Sources

- Springsted – www.springsted.com
- Bloomberg – www.bloomberg.com
- SIFMA – www.sifma.org
- National Association of Realtors – www.realtor.org