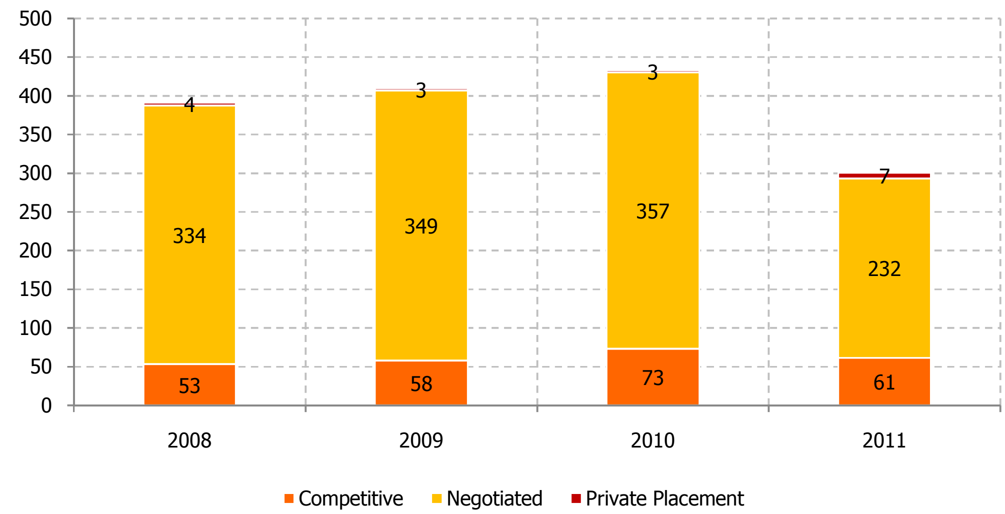
Muni Market Resilience:why the sell side headcount matters

- The muni market is under pressure, but the wave of defaults has not materialised.
- Three key trends suggest the outlook is cautiously positive: (1) the resilient secondary trading volumes; (2) evolution in the investor 'mix'; and – crucially - (3) muni staffing levels.

In the not-too-distant past, various market observers predicted a wave of municipal bond defaults in 2011; the famous ex-bank analyst Meredith Whitney went further than most, expecting 'hundreds of billions of dollars worth' [of defaults] in the past year. This, of course, would have caused a seismic shock to a market already struggling with the current global macro crises.

On the face of it, there were valid reasons for concern: the notional volume of overall primary issuance plummeted by 30% y/y in 2011, and by 35% in the more profitable negotiated deals.

Bond notional issued by US Municipalities(US$bn)



Source: SIFMA

The banks competing in this market – most of whom have a front-row view of the credit worthiness of municipalities – did not share this pessimistic view. Nor, it seems, did investors, as 30-day average secondary trading volumes decreased by mere 10% in three years to end-2011.

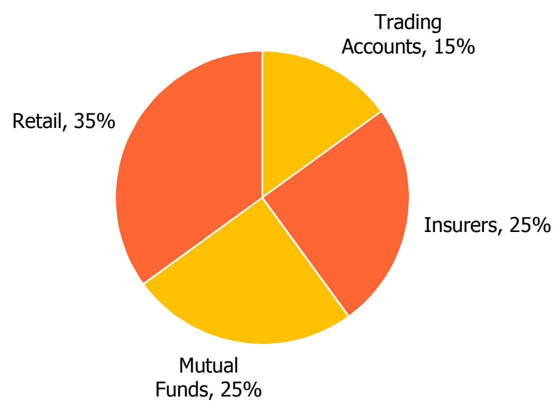
30 Day Average Customer Notional Traded (US$m)

Source: SIFMA

This investor base is somewhat different to that of a few years ago. Our research has found that the number of Muni-focused mutual funds has declined, while trading accounts, insurers and individual investors have grown in importance as buyers of muni securities. The growth of the retail investor base has been particularly useful for sell-side firms, as the bid-offer spreads that banks can charge retail clients partly offsets the decline in trading volumes. As a result, a number of investment banks have agreed distribution deals with brokers and private banks.

A 'typical' high yield municipal new issue might now see the distribution to investors as follows:

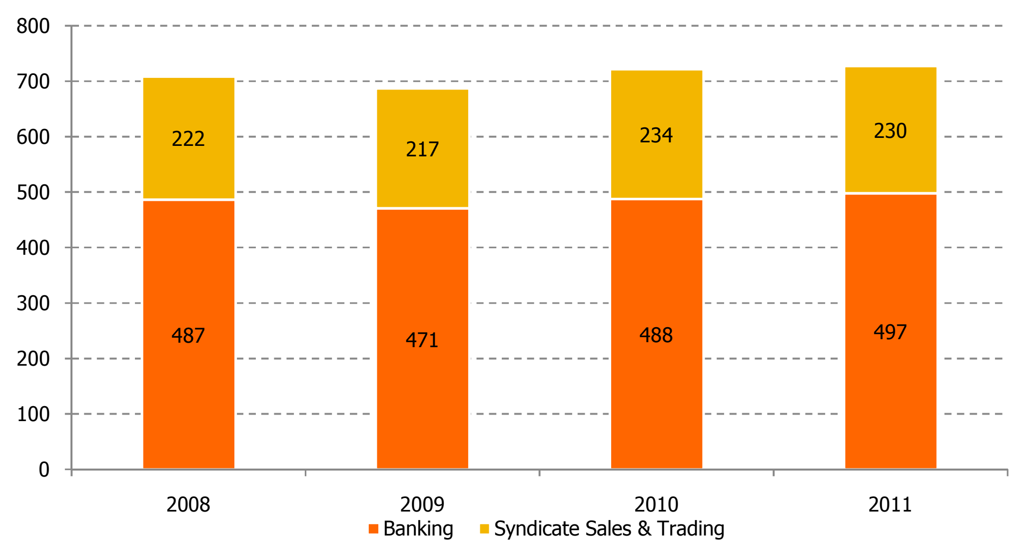
'Typical' distribution for a high yield municipal new issue (mid-2011)



Source: Tricumen

Finally, and in our view crucially, our analysis of Muni departments' staffing levels suggests that banks are cautiously optimistic regarding the outlook. From the end of 2008 to date, the average headcount at Barclays Capital, Citigroup, JPM and Morgan Stanley actually grew; the increase was modest, but in stark contrast to 5-20% overall headcount reduction seen in other areas. We also note the steady growth of origination and banking headcount over the past three years: to us, this indicates that the investment banks closest to municipalities view the odds of imminent market collapse as being very remote indeed.

Average Front Office Producer Headcount (excludes research staff)



Source: Tricumen. Figures based on the average headcount at Barclays, Citigroup, J.P.Morgan, Morgan Stanley. Goldman Sachs and Bank of America were excluded, for reasons of client confidentiality)

Notes & Caveats

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