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Economic Watch

U.S.

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Economic Analysis

Variable Rate Demand Obligations Update

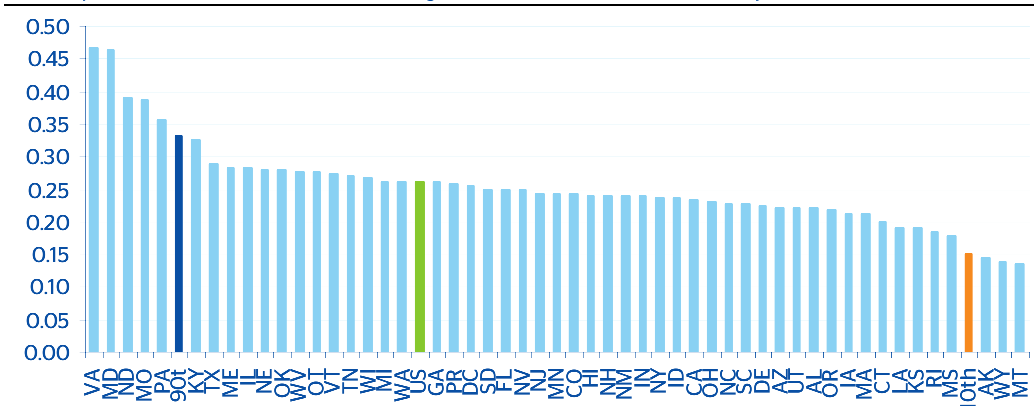
Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

- **This week's data reveals $5.5bn in offerings, 37.6% of which is within the BBVA Compass Footprint**
- **Short-term rates are expected to follow our forecast of a first Fed hike in March**

Variable-rate demand obligations (VRDOs) effectively transform long-term municipal obligations with fixed rates into liquid short-term debt with variable rates. VRDOs often have long maturities, but the highly-frequent interest rate reset periods offset this maturity structure. The owner of a VRDO may return the instrument to the agent at set times, upon which they receive the par value of the bonds. VRDOs commonly entail a reset period of one week to one month. An additional feature of VRDOs is a letter of credit (LOCs) from a financial institution. LOCs offer an extra layer to buyers of VRDOs as the financial institution providing the LOC must pay principal and interest to bondholders in the event of default.

On tap this week from dealers in VRDOs are around $5.5bn in 1,424 offerings with an average rate of 0.26% and 90th and 10th percentiles of 0.33% and 0.15%, respectively. The BBVA Compass Footprint represents around 37.6% of this week's offerings, or a little over $2bn. The top six dealers hold nearly 92% of the issuances across the United States as of this week's data. Over the course of 2011, some $53.3bn in municipal LOCs are expected to expire, according to Thomson Reuters. Although this week's data shows states at varying levels of rates, some of the data may simply be the result of particular types of municipalities or political subdivisions headed to the market this week rather than a statewide effect.

Chart 1
State-by-state variable-rate demand obligations offered rates, week of April 13th 2011

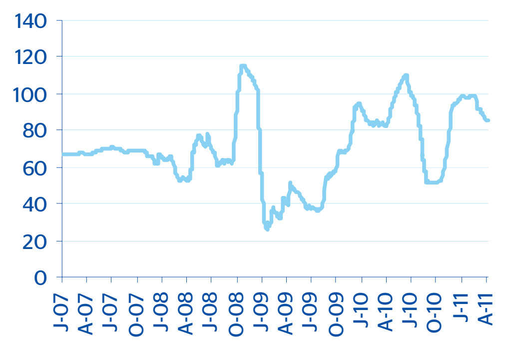


Source: BBVA Research and Bloomberg; Note: 90th and 10th denote percentiles of all offerings for this week

At the end of 2010, VRDO rates were particularly advantaged over SIFMA and LIBOR levels, but recent strains in the short-term funding market have caused a tightening in many different cash management instruments. At the beginning of February, the Department of the Treasury ended the Supplementary Financing Program, which provided a considerably supply of short-term bills to the market. With the expiration of this program, billions from depository institutions have piled up as excess reserves at the Fed or, to the extent possible, in other commonly-used short-term cash management devices. This tightening in short-term interest rates is also reflected in the VRDO market.

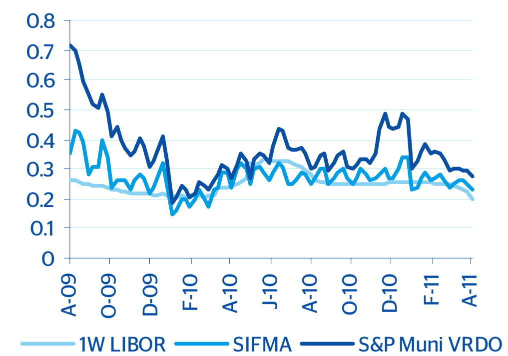
Market participants also tend to focus on the SIFMA/LIBOR swap ratio, as occasionally some arbitrage opportunities arise from discrepancies in the tax-free and taxable short-term cash market rates. As many municipal credit instruments are tax-advantaged, financial firms compare this rate (alongside the attendant credit risk) to instruments of similar tenor. For example, if the marginal tax rate is 35% and the SIFMA/LIBOR ratio is performing better, it may be feasible to exchange one variable rate for the other in a swap. However, the SIFMA/LIBOR ratio is also affected by supply and demand considerations, market disruptions, new tax regulations, and interest rate changes, so it is not a wholly straightforward ratio. Nonetheless, the latest data suggests that the SIFMA/LIBOR ratio has declined recently from its highs. The long-run average is around 65-70, depending on the time frame.

Chart 2
SIFMA/LIBOR Ratio



Source: SIFMA and Bloomberg

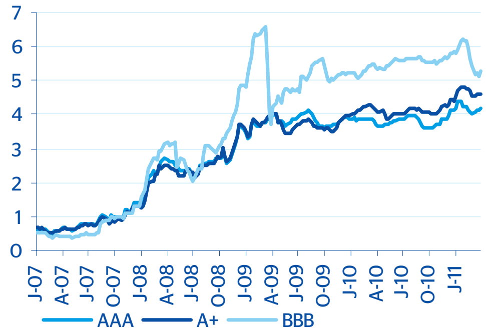
Chart 3
Selected variable interest rates



Source: Bloomberg

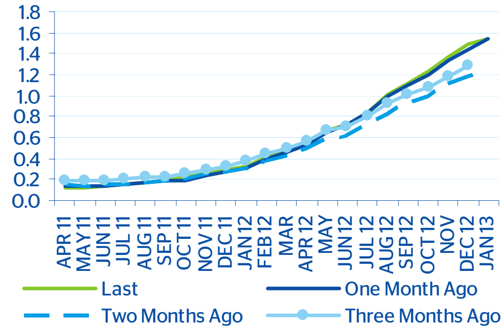
Dealers of VRDOs focus on a variety of metrics to set interest rates. Dealers will also consider the size of the issuance, the sector of the municipality or political subdivision, the quality and collateral of the security, the state of the issuance, prevailing market demand, and the dealer's cross-selling relationship with the issuer. Yield curve spreads, calculated as the difference between the 2-year and 30-year municipal bond rates, for lesser-rated municipal securities have compressed lately compared to their position some months ago. However, the yield curve spread for AAA municipals is slight above 400bp, which is slightly elevated for the post-Lehman era. Naturally, the prevailing term structure of interest rates will provide a starting point for pricing. In particular, we expect that the Federal Reserve will not increase its target rate throughout 2011. Although recent speeches by some Fed officials imply a more hawkish bias, we believe this is more the result of a renewed communications strategy aimed at containing inflation expectations. These speeches also represent the plethora of opinions growing within the Fed and the increasingly-approaching need for policy normalization. The timing and the pace of the rate hikes will depend on macroeconomic conditions. Given our forecast of low inflation (limited pass-through from recent commodity prices) and moderate growth (still constrained by high resource slack), we believe that the Fed will begin rate hikes around March 2012.

Chart 4
Yield Curve Spread for Municipals (30Y-2Y)



Source: BBVA Research and Bloomberg

Chart 5
Fed Funds Expectations (%)



Source: BBVA Research and Bloomberg