AVIATION SECTOR & MUNICIPAL BOND MARKET OUTLOOK

JANUARY 2015

AIRLINE HEALTH

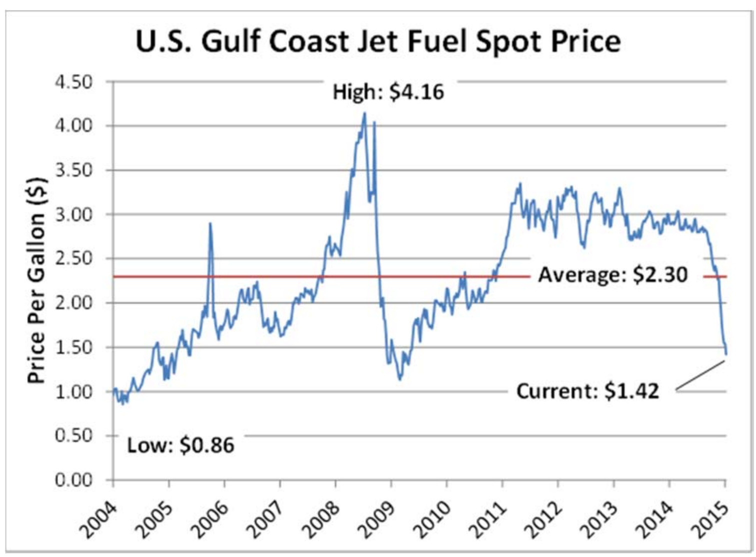
Domestic air carriers have remained profitable for over three years. System-wide, 2014 pre-tax profits are expected to be approximately $15 billion with projections for next year above $20 billion. The improving economy has helped passenger demand and enabled pricing power as air fares have risen. The strong profitability is also due to:

- The payback of debt that is reducing interest expense
- Increased ancillary revenue (change fees, preferred seating, baggage fees, etc.)
- Lower fuel expense
- Continued capacity discipline through the matching of the supply of seats with the demand for airline tickets
- Better asset utilization from fuel efficiencies and fleet and gate optimization

Increasing turns per gate and the continued upgauging of aircraft is helping airlines realize cost economies of scale. Raymond James' airline analysts expect a replacement ratio of two large (76-seat or above) regional jets for every three small (50-seat) regional jets, in addition to more capacity on mainline jets. American and United are re-banking several of the large hubs (Chicago, Dallas, Denver, Houston, Miami) whereby arrivals and departures are bunched closer together. Re-banking is expected to optimize schedules and boost revenue from better connecting options. This supports seat capacity increases but may lead to more in-terminal congestion and boarding delays at airports.

FUEL

U.S. jet fuel prices have experienced almost three years of lower than normal volatility remaining range bound at $2.50–$3.50 per gallon from January 2011 to September 2014. But jet fuel prices can be volatile. The graph to the right shows that after peaking at $4.16 per gallon in July 2008, the price fell to $1.13 per gallon in March 2009. Recently, low demand and high supply precipitated another freefall as the price of fuel has been cut approximately in half since June 2014 and currently stands at $1.42 per gallon. The crack spread, or additional cost to refine crude into jet fuel, has remained stable at 9–13% of the total per barrel cost of crude since 2009. As a key driver of the price of jet fuel, the crack spread similarly spiked in 2008 to over 20%. If fuel, which accounts for 35–40% of domestic carriers' total expenses, remains low, airline earnings will continue to rise, facilitating flexibility, such as the ability to add seats or frequencies.



RAYMOND JAMES CONTACTS:

D.J. Mehigan
Managing Director
804.225.1147
DJ.Mehigan@RaymondJames.com

J.P. Hickey
Senior Vice President
901.579.3514
JP.Hickey@RaymondJames.com

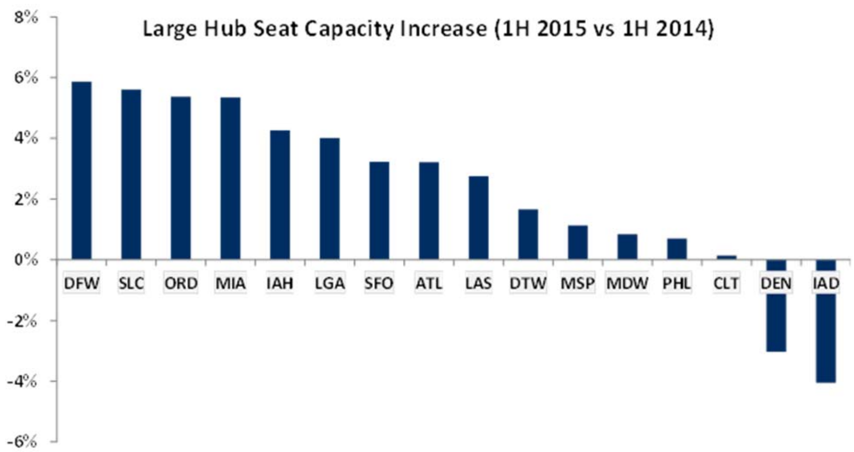
AVIATION SECTOR & MUNICIPAL BOND MARKET OUTLOOK

SEAT CAPACITY

Despite both Delta and American recently stating they will maintain capacity discipline, Raymond James Airline Equity Analyst Savi Syth recently stated:

"Capacity discipline is holding and, so far, airlines have been circumspect in significantly changing capacity plans in response to lower fuel prices. However, we expect some capacity creep, particularly through increased utilization, as certain flights become profitable at lower fuel prices. A large and sustained drop in fuel prices may not be a good thing for the industry in the longer term, as it lowers barriers to entry."

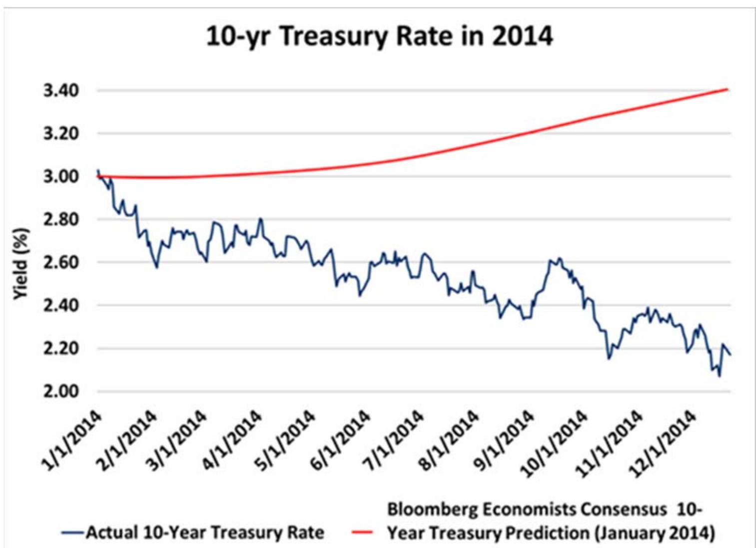
Using forward-looking data for the next six months, airline schedules are reliable predictors of airport enplanements. Seats are still being added even in today's high load factor environment (2014 average load factor was 84%). Based on actual schedules for airline seats out of all U.S. markets, the first half of the 2015 schedule shows an increase of 2.7% over the first half of 2014. Moody's recently changed its outlook for the airport sector from Stable to Positive and stated in a bullish December 12, 2014, report: "*For 2015, we expect enplanement growth will be near 3.5%, which will also result in stronger-than-expected financial metrics.*"



Most large hubs will continue to realize seat gains, and statistics show that medium and small hub airports are also growing – now at only a slightly lower pace than the large hubs – so the growth advantage large hubs have had is waning. Hubs cannot be painted with one stroke – the bar chart to the left (approximately one-half of all large hubs) shows a wide range in seat projections for the first half of 2015.

INTEREST RATES

In January 2014, the Bloomberg Consensus of 64 economists surveyed [the red line in the chart to the right] predicted the 10-year U.S. Treasury would rise throughout the year and be at 3.40% by year-end. But at the end of 2014, the 10-year Treasury was nearly 100 basis points (1.00%) below where it started the year and it currently stands at 1.76%. Municipal interest rates followed treasuries with the 10-year and 30-year yields down by 75 basis points and 137 basis points, respectively, resulting in some flattening of the tax-exempt yield curve.



AVIATION SECTOR & MUNICIPAL BOND MARKET OUTLOOK

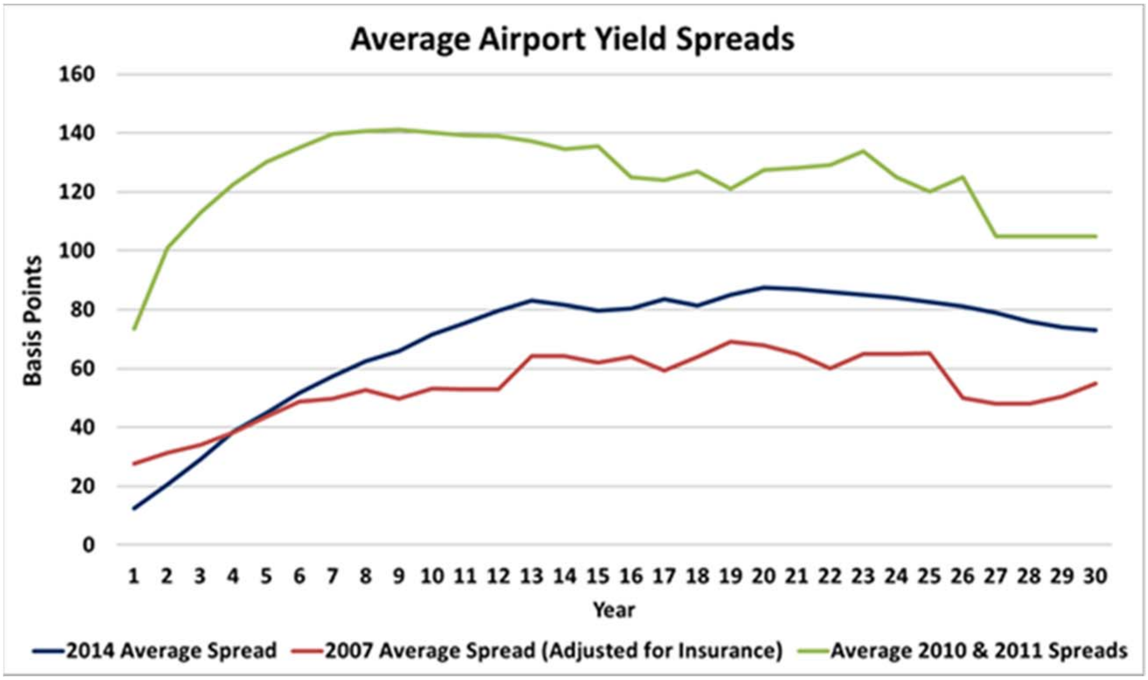
INTEREST RATES *(cont.)*

Declining yields were a result of weak economic conditions overseas and a flight to U.S. securities. U.S. Gross Domestic Product growth, which has averaged approximately 2.0% over the past five years, is expected to exceed 3.5% in 2015. If this economic strength continues in the U.S., the Fed is expected to tighten its monetary policy by increasing the federal funds rate. Barring a much stronger than expected recovery, we expect steady to only slowly rising interest rates even if the Fed tightens in mid-2015, as many expect.

Raymond James Consulting Economist Dr. Donald Ratajczak expects that once tightening begins, the Fed will raise rates only 100–125 basis points a year until it reaches an expected equilibrium rate that some estimate at approximately 3.50%. Assuming long-term interest rates also rise, but at a slower pace than short-term increases, it will take several years before a meaningful flattening of the yield curve materializes.

TIGHTENING OF AIRPORT CREDIT SPREADS

In addition to low absolute yields, airport issuers have experienced lower interest rates as a result of credit spread tightening. The airport credit spread tightening has been driven by investor demand for municipal bonds, especially higher-yielding airport paper. Examining spreads from over $14 billion of airport bonds, 2014's average municipal airport credit spreads [the blue line below] are approaching pre-financial crisis levels [the red line] and have compressed significantly from the levels in 2010 and 2011 [the green line].

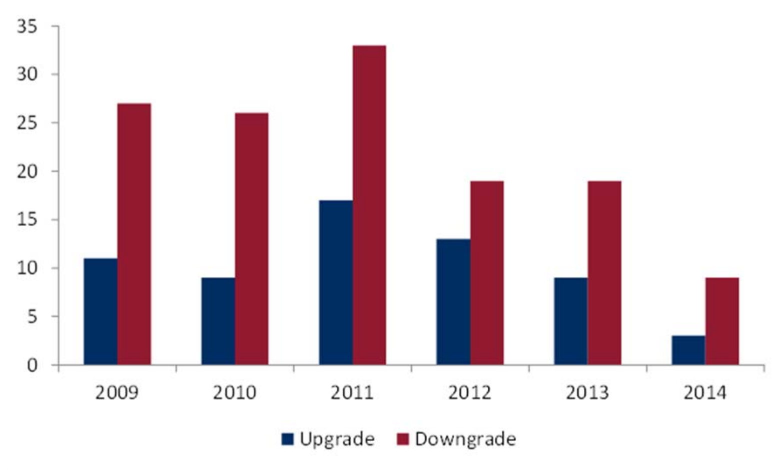


We believe municipal credit spreads will remain compressed this year and near their pre-financial crisis levels. However, we do not anticipate significant, further spread compression. Our municipal underwriting desk predicts a flat to modest increase in municipal volume for calendar year 2015. Barring an unforeseen event such as a severe drop in municipal volume or a dramatic global crisis, we believe the spread compression should ease and spreads may trend slightly higher over the near to mid-term.

AVIATION SECTOR & MUNICIPAL BOND MARKET OUTLOOK

TRENDS IN AIRPORT CREDIT RATINGS

Airport and airport-related credits have been under pressure since traffic fell in 2008-2009. Since 2009, over 195 credit rating upgrades or downgrades have taken place. The chart to the right shows the activity by year for a set of approximately 200 Fitch, Moody's and S&P airport credits. In total, downgrades have outpaced upgrades by a factor of 2.15 to 1. Small hub airports, which represent about 25% of all airport credits, have experienced a disproportionate amount of downgrades (over 40%) and a lack of upgrades (less than 10%) since 2012 as airline consolidation and capacity rationalization has hurt traffic levels and credit metrics at several smaller airports.



MUNICIPAL BOND INSURANCE

The number of bond insurers has fallen from a high of seven mono-line, AAA-rated entities in 2007 (Ambac, Assured Guaranty, CIFG, FGIC, FSA, MBIA, XL Capital) to three viable, municipal bond insurers today (chart to the right).

Insurer	Rating
Assured Guaranty Municipal (AGM)	AA / A2
Build America Mutual (BAM)	AA
National (formerly MBIA)	AA- / A3

47% of the total par of all municipal bonds was insured in 2007, but that percentage fell to a range of only 3–9% from 2009–2014. The true insurable, municipal market includes issuers rated in the A or BBB category, which comprises 25–30% of total par. In 2013, 12% of the combined A/BBB municipal issuance used bond insurance, and in 2014, over 20% of the true insurable, municipal market used bond insurance.

As discussed above, airport issuers have experienced spread compression. This fact, combined with the fact that airport investors are often yield-seekers, makes it more difficult to find investors willing to pay up for bond insurance, and it is difficult to get investors to forgo the spread needed to reach acceptable return hurdles. Nevertheless, several airports used AGM and BAM in 2014 such as Burlington, VT (BBB-/Baa3), Colorado Springs, CO (BBB+/Baa1), Dayton, OH (A-/BBB+), and Tulsa, OK (BBB+/Baa1), as well as higher-rated airport credits such as Baltimore, MD (A+/A2) and Las Vegas, NV (A+/A1). Even though we expect airport upgrades to outpace downgrades, we believe the amount of insured airport paper will slowly increase and the case for bond insurance will strengthen over time, for the following reasons:

- ✈ All of the bond insurers now have stable outlooks.
- ✈ The bond insurers now are willing to insure as little as a single maturity.
- ✈ Additional competition (e.g. National joins AGM and BAM and begins writing airport bond insurance policies) should help facilitate more participation.

RAYMOND JAMES®