Municipal Market Comments

Ascent Investment Partners

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S&P Criteria Change Expected to Raise Many G.O. Ratings

On Sept. 12, Standard & Poor's released updated rating criteria for local government general obligation bonds in the U.S. The new criteria apply to cities, counties and towns of all sizes. Excluded from the new criteria are state level issuers as well as what S&P refers to as "special purpose districts," such as school districts, library districts, fire protection districts and other similar entities. S&P notes in its release that in light of a gradually improving economy, it expects that as many as 30% of its 4,000 existing local government G.O. ratings could be raised in the coming months, while approximately 10% of ratings could be lowered. S&P's expectation is that rating changes would generally be one notch (e.g., from A+ to AA-), though we expect that there could be a few outliers that experience rating moves of two or more notches.

S&P's changes to its local government G.O. rating criteria do not reflect a significant change of perspective on how the agency views credit risk in tax-backed bonds. Rather, the agency is moving its rating framework to be more in line with its approach to corporate bonds and municipal enterprise debt. S&P will continue to analyze the same "key factors": institutional framework, economy, management, budgetary flexibility, budgetary performance, liquidity, and debt and contingent liabilities. The change relates to how S&P weights each of those factors relative to the others and the method by which the agency interprets the numerical scores generated by its factor weighting.

What does this mean for investors? Over the next 12 months, we expect to see an increasingly strong positive rating trend for the universe of S&P rated issues. We would not view this as an indication that credit quality was substantially improving in U.S. municipalities. It compares more closely to Moody's rating recalibration in early 2010, when Moody's raised a huge number of municipal bond ratings in an effort to more closely align its municipal ratings with its corporate ratings.

That said, S&P has shown a solid positive trend in its local government ratings over the past year. This stands in marked contrast to Moody's, which continues to show strongly negative trends in the ratio of downgrades-to-upgrades for its rated municipal bonds. We expect that S&P's action will continue to power a modest divergence in credit perception between the two agencies and could result in a higher number of split ratings – situations in which one agency rates a bond in one category while the other rates it in a higher or lower category (e.g., Moody's rates a bond A1 while S&P rates it AA-).

Of note in the criteria report is S&P's discussion of general obligation credit risk. The municipal market has experienced a significant amount of weakness in recent months, some of which is attributed to investors' concerns over credit following the Detroit bankruptcy. In the same way that Meredith Whitney spooked many investors out of municipal bonds with her predictions of "hundreds of billions of dollars of defaults," Detroit's effort to haircut much of its G.O. debt through the Chapter 9 process has created selling pressure from concerned investors.

In the report, S&P outlines its view that the full-faith-and-credit pledge from local governments remains a very strong security structure. S&P looks at historical default performance and the structural incentives – political, legal and financial - for municipalities to support their debt by all means necessary. The agency concludes (and we concur) that the G.O. bond structure has experienced "miniscule" investor losses even during the most challenging economic periods and that G.O. bonds will continue to provide, in aggregate, very high credit quality going forward. The situations that present the greatest investor risk generally involve rapidly changing financial positions due to unforeseen shock or long-term credit deterioration.

We will continue to monitor S&P's implementation of its criteria revision and the effects on the broad municipal market and on specific issuers. As ratings change, up or down, we will continue to carefully assess the underlying credit characteristics of the bonds we buy and hold. We believe that careful credit analysis can uncover significant opportunities to add value and to avoid risk, especially in changing rating and interest rate environments.

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