

Municipal Market Comments



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from  Montage Investments

Supercommittee Failure Won't Trigger USA Downgrades...Yet

On Monday, November 21, the Congressional "supercommittee" announced that it had failed to reach agreement on a plan to reduce the federal budget deficit by \$1.2 trillion over the next 10 years. Following Monday's announcement, all three rating agencies affirmed their current ratings and outlooks on the US – **Aaa/negative** by Moody's, **AA+/negative** by S&P, and **AAA/stable** by Fitch. As a result of the failure of the committee to craft a deficit reduction plan, automatic spending cuts of \$1.2 trillion are scheduled to be triggered beginning in January 2013. Our expectation is that members of Congress from both sides will try to pass legislation over the next year to limit those cuts. Clearly, the fight over how to address the country's structural budget deficit will dominate the political landscape going into the 2012 election year. The direct implications for tax-exempt bonds and for public debt issuers will be driven by developments in the budget debate, so they remain uncertain at present.

As we discussed in last week's Municipal Market Comment, the larger issue for bond markets is the potential impact of the Supercommittee failure on the credit ratings of the United States. The Supercommittee itself was formed out of the failure of Congress to effectively resolve the debt ceiling debate in August and the larger issues around the structure of the US budget. While S&P downgraded the US to AA+ as a result, both Moody's and Fitch maintained their triple-A ratings pending developments with the Supercommittee. While the immediate response from the rating agencies was affirmation of their ratings and outlooks, we view this as a near-term position that is subject to revision downward within the next six months depending on the actions taken by Congress and the President.

While Moody's commented that the committee's failure "would be informative for the rating analysis but not decisive, and failure to reach agreement would not by itself lead to a rating change," we expect that a lack of progress by Congress on implementing meaningful budget controls could prompt that agency to make a downward revision to the rating in 2012. Negative rating pressure would be heightened should the economic recovery slow or stall over the next two to three quarters or should there be serious financial market shocks resulting from the turmoil in European sovereign debt markets.

S&P and Fitch were more direct in their comments this week. While Fitch did affirm its rating and stable outlook for the present, it noted that it would update its analysis of the US based on the Supercommittee's results and that failure "would likely result in a negative rating action – most likely a revision of the rating Outlook to Negative, which would indicate a greater than 50% chance of a downgrade over a two-year horizon. Less likely would be a one-notch downgrade," to AA+. S&P followed by stating that the failure was consistent with its current rating and reflected in the previous downgrade, but noted that it expected "the caps on discretionary spending as laid out in the Budget Control Act of 2011 to remain in force. If these limits are eased, downward pressure on the ratings could build."

Given the political dynamics of the current budget debate, and the 2012 election considerations dominating political thoughts, we are not confident that Congress can craft any meaningful deficit control legislation over the next year. We also see a great deal of political motivation on the part of members of both parties to try to limit automatic budget cuts. Given the strength of US Treasury bonds since the August S&P downgrade, Congress may not view the potential impacts of additional rating downgrades as outweighing other political and policy considerations.

A handwritten signature in black ink, appearing to read "B. Tournier", with a long horizontal flourish extending to the right.

Brian Tournier
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