Municipal Market Comments

Ascent Investment Partners

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Natural Disasters Not a Threat to Muni Ratings

As Hurricane Irene bears down on the U.S. Atlantic coast, it is natural for investors to consider what the implications might be for municipal bonds issued by municipalities in the path of the storm. While damage from hurricanes, tornadoes, flooding, earthquakes and other natural disasters can be substantial, the impacts on municipal bond ratings from natural disasters have historically been extremely limited. In our 20 years in the municipal market, we have not seen any payment defaults on municipal bonds due to natural disaster impacts. The very few modest rating downgrades that we have seen were all related to Hurricane Katrina's unprecedented impact on the New Orleans area and were secured by issuers that were generally of single-A to triple-B credit quality.

Short-term budget and cash flow pressures on municipalities' finances are a common outcome following a disaster. These pressures are mitigated through a combination of state assistance and FEMA disaster aid that typically reimburse between 80% and 100% of disaster-related expenses. Unlike the corporate market, where companies may be exposed to uninsured disaster-related costs and other direct business impacts, municipalities have an insurer-of-last-resort in FEMA that provides both short-term help to mitigate disaster cleanup and recovery and also long-term aid to support reconstruction. In fact, the most common outcome from natural disaster is a regeneration of the local infrastructure and economy due to rebuilding and reconstruction activity.

In general, we do not recommend that investors sell municipal bonds that may be in disaster-prone areas or subject to weather-related headline risk. By carefully selecting bonds secured by issuers that have strong inherent credit quality and adequate liquidity, investors can take comfort in the extremely strong performance of high-quality municipal bonds to literally "weather the storm."

Economic Cycle Continues to Weaken Municipal Finances; Downgrades Outpace Upgrades Again in 2Q

As the financial markets debate whether the U.S. economy could slip back into recession, municipal finances remain mired in a revenue downturn that began in 2007. In the second quarter of 2011, Moody's downgraded three municipal ratings for every one that was upgraded, marking the third consecutive quarter that Moody's downgrades-to-upgrades ratio exceeded 3:1. While Standard & Poors actually upgraded more ratings than it downgraded in the second quarter – and has had a positive upgrade-to-downgrade ratio in every quarter since before the financial market disruption and resulting recession – the absolute number of downgrades by S&P through two quarters of 2011 nearly totals the number of downgrades by the agency in all of 2010.

Historically, the financial performance of municipalities has typically lagged the national, state and/or regional economy by 18 to 24 months, resulting in cyclical lows for municipal finances approximately two years after the depths of an economic downturn. The rating cycle may take another 12 to 18 months beyond that to reflect the full impacts of financial deterioration and reductions of reserve levels to balance budgets. In the current economic cycle, given the unprecedented decline in housing values nationally and the one- to two-year lag typical for property tax assessments, it has only been in the last two fiscal years that municipalities with a heavy dependence on property taxes have begun to feel the full brunt of the downturn. States, which rely most heavily on sales and income taxes for the bulk of their revenues, have begun to see revenue growth again after the historic drop in revenues they experienced from 2008 through 2010. For local issuers, though, the impacts of declining real estate values continue to weigh on their budgets and credit quality. Absent a significant upturn in the national economy in the near term, we would expect that municipal ratings generally will continue to remain under pressure well into 2013 and possibly beyond.

While municipal credit quality is under pressure generally, investors should not make investment decisions based on broad generalizations of market health. More than many other sectors, munis are an extremely diverse universe of issuers, each with unique characteristics that may react very differently to broad economic trends. It is important to note that even with a general downtrend in credit quality, there are a large number of issuers that are improving in credit quality even in these tough economic times. Fundamental, research-driven investment selection can insulate investors from a great deal of credit risk while still providing market returns.

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