

Municipal Market Comments



December 22, 2011

from  Montage Investments

Fitch Revises 2012 Outlook for States to Stable

In a report dated December 15, 2011, Fitch Ratings discussed its outlook for U.S. state ratings for 2012. In the report, Fitch outlines its rationale for revising its outlook for the states to stable in 2012 from its negative outlook in 2011. Of the 43 states Fitch currently rates, it has stable rating outlooks on 38, negative outlooks on three and two positive outlooks. Fitch's view on state credit quality for the coming year reflects "the recurring budget measures that most states took this year and the expectation of their continued commitment to budget balance in an environment of continued slow economic and revenue recovery."

Fitch's outlook for the states is predicated on a variety of key rating issues. Buoying the improvement in states' outlooks are:

1. *Lower budget gaps for Fiscal 2013.* States as a group faced significant budget shortfalls for their 2012 fiscal years (almost all of which began on July 1, 2011) as a result of the expiration of federal stimulus funding in June 2011. States generally closed those FY2012 budget gaps using expenditure reductions, augmented with a wide variety of revenue enhancements. Looking ahead to Fiscal 2013, states have generally put in place budget adjustments that, combined with ongoing revenue improvements, will substantially reduce their projected FY 2013 budget gaps.
2. *State revenues adjust quickly to reflect the economy.* The majority of states' revenues are generated by economically sensitive income and sales taxes. While this hurts state revenue flows in economic downturns, it can help states rapidly rebuild their finances during periods of regional and national economic growth.
3. *Continuing focus on expenditure controls.* Widespread voter opposition to tax increases, coupled with structural and political limitations on raising taxes and fees, forced states to do the bulk of their budget balancing through expenditure cuts. Each state differs in the particulars, but as a group states have cut budgets largely through workforce reductions and through reductions in state payments. While state cuts have raised the pressure on local school districts, state colleges and universities and other agencies and municipalities dependent on state aid, this approach has helped maintain states' budget integrity.

Fitch did note that there are some significant negative pressures on state credit quality, most notably: rising Medicaid costs and the uncertainty over Medicaid funding levels from the federal government; risks of federal funding reductions to the states due to federal deficit reduction efforts; and pressures from retiree benefit obligations and the need to fund future benefits.

Fitch also noted that its outlook could change if it saw evidence of states reaching the limit of spending control due to legal or political limitations, signs of unexpected economic deterioration or substantial reductions in federal program funding that impacts state budgets.

National Public Finance Downgrade Not Expected to Have Market Impacts

On December 19, 2011, Moody's downgraded its rating on National Public Finance Guarantee Corp. (NPFG) to Baa2 from Baa1 and maintained a negative outlook on the rating. NPFG is the renamed municipal insurance successor to MBIA, following that company's restructuring in 2009. Throughout the 1990s and up until the collapse of the municipal bond insurance market in 2008, MBIA was rated Aaa/AAA/AAA and was one of the most active municipal insurers in the marketplace.

Numerous municipal bonds remain outstanding that are insured by NPFG and now carry Baa2 ratings by Moody's. Ascent's approach to NPFG-insured bonds has been to look past the insurance and evaluate the underlying issuer. In most cases, the underlying issuer's credit quality is much higher than the credit rating of NPFG, though the market does not always value these bonds that way. We do not view this rating action as reason to sell NPFG-insured bonds provided the underlying credit fundamentals of the issuer remain sound.

A handwritten signature in black ink, appearing to read "B. Tournier".

Brian Tournier
Director of Research
Ascent Investment Partners

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