



SPECIAL BULLETIN

Municipal Bonds: What to Expect from the U.S. Debt Downgrade

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On Friday evening, August 5, Standard & Poor's downgraded the long-term sovereign debt rating of the United States by one notch, from AAA to AA+. Additionally, they indicated that further downgrades are possible within the next two years.

WAS THE DOWNGRADE A SURPRISE?

No, this action was well broadcast and the market has been largely prepared for it. The surprise was the timing in that it occurred so quickly after the debt ceiling agreement was reached.

WHY DOES THIS MATTER FOR MUNICIPALS?

Municipal credit is linked either directly (backed by U.S. government securities) or indirectly (government spending, federal employment, Medicaid). We will likely see many downgrades especially on issues directly linked to the U.S. government's debt rating, such as pre-refunded bonds and agency backed housing bonds. Moody's estimates there are 7,000 issues representing \$130 billion that would be immediately impacted. This represents a mere 3.5% of the \$3.7 trillion municipal bond market.

ARE YOUR BONDS STILL SAFE?

1. Yes. The fundamentals have not changed and the U.S. debt rating downgrade was considered highly likely before action was taken. The real threat, in our view, is that this will weaken investor confidence and put additional pressure on domestic and global economic growth.
2. State governments have been way ahead of the federal government in implementing structural budget changes and credit trends have been generally positive (although admittedly uneven). They have accepted for some time that there will be no Federal bailout and have taken austerity steps on their own.
3. Keep in mind that Moody's and Fitch both affirmed their AAA rating of U.S. debt.
4. It's even reasonable to expect a flight-to-safety within the municipal bond market to high grade issuers. Examples include university bonds issued by Harvard and Stanford and debt backed by the Getty Foundation.

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WHAT IS LIKELY TO HAPPEN IN THE SHORT-RUN?

1. Pre-refunded bonds and agency backed housing bonds will be downgraded by S&P in lockstep with the U.S. rating due to their direct and explicit link to U.S. government debt.
2. Next, S&P will do a comprehensive review of credits with indirect links to the U.S. government and adjust their ratings accordingly. For example, it is unlikely that they will continue to rate a state (“sub-sovereign debt”) higher than the U.S. (“sovereign debt”). States will be considered carefully based on their reliance on federal spending. S&P has identified five states for immediate review: Maryland, Virginia, South Carolina, Tennessee and New Mexico. California and New York have not been mentioned as high priorities.

WHAT ELSE COULD HAPPEN IN YOUR PORTFOLIO?

Looking out over the next several months and into 2012 we expect more clarity on federal fiscal austerity effects on state and local budgets. We expect continued volatility in market yields and liquidity will continue to be under pressure. Nervous retail investors may continue exiting mutual funds but we expect further inflows into high grade municipal separate accounts.

DOES THIS CHANGE CITY NATIONAL ASSET MANAGEMENT’S MUNICIPAL BOND STRATEGY?

No. We will continue to focus on single-A and higher issues and remain heavily concentrated in the general obligation and essential service revenue bond markets. Even though pre-refunded bonds will be downgraded, they remain very high quality and we are unconcerned about their repayment at maturity. That said, we have been sharply underweight pre-refunded bonds for quite awhile due to the lack of nominal yield. If the economy continues to weaken, we may look to extend average duration to capture some of the premium available from a further decline in rates.

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