



STANDISH

Tax Sensitive Fixed Income



U.S. Debt Ceiling and Municipal Credit

U.S. Debt Ceiling, Deficits and Municipal Credit

The failure of the federal government to raise its debt ceiling has the potential to cause problems for certain municipal credits. These problems could be caused directly by an outright failure of the federal government to make payments needed for debt service, in the case of bonds whose debt service is paid by the federal government such as pre-refunded bonds. Alternatively, certain high grade municipal credits could be downgraded in anticipation of economic factors brought on by a downgrade of the U.S. government.

Loss of the U.S. Government's AAA ratings

Both Moody's and S&P have placed their Aaa/AAA ratings of the U.S. Government on Creditwatch due to the lack of an agreement over the raising of the U.S. debt limit. Both rating agencies state it is likely the U.S. government's debt ceiling will be raised but cite an increased possibility that it will not.

In addition, both agencies have placed their ratings of municipal bonds whose credit ratings are linked directly to that of the U.S. government on negative Creditwatch. These bonds include re-rated pre-refunded bonds (both U.S. Agency and U.S. Treasury collateral) and housing bonds backed by the Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae) and Freddie Mac.

Despite the certain similarities in Creditwatch status between Moody's and S&P, there were some key differences in the rating agencies' Creditwatch scenarios:

Moody's: The primary concern raised in Moody's Creditwatch is whether the lifting of the U.S. government's debt ceiling can take place before the critical August 2, 2011 deadline, so that the U.S. government can fund its operations. Moody's indicated that if the U.S. government's debt ceiling were raised before that date, the Aaa rating would be retained. The rating outlook could be revised to stable if the rating agency were satisfied that the accompanying deficit reduction plan was significant. An inadequate deficit reduction plan could lead to a negative outlook but not a downgrade.

In addition to municipal bonds whose ratings are directly tied to that of the US, Moody's has also placed 5 of the 15 states with Aaa ratings on Creditwatch as a result of the Creditwatch status of the U.S. government's rating. The 5 are Maryland, Virginia, Tennessee, South Carolina and New Mexico and Moody's considers these 5 to be more subject to economic decline in the event of a U.S. downgrade than the 10 other Aaa rated states. Moody's research indicates that in other cases where a sovereign

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government has been downgraded there has been resulting economic decline, large budget deficits, higher taxes and other impacts that can have negative consequences for sub sovereign credits such as state and local governments. Moody's plans to review these credits and decide which should be downgraded in the event the U.S. is downgraded.

Moody's focus is currently on Aaa rated municipals because issuers with such pristine ratings are expected to have little volatility or risk associated with them. The threshold for downgrade is therefore much lower for the highest ratings – lower rated credits can be subject to more financial or economic risk before they are downgraded. Nevertheless, Moody's has indicated it will be reviewing lower rated credits once their review of Aaa ratings is complete, though no time frame was identified.

S&P: In contrast, S&P's Creditwatch announcement stresses concern over deficit reduction as well as the ability to raise the debt ceiling. S&P stated they may downgrade the U.S. in July without sufficient progress in view of the difficult politics involved even if the debt ceiling is raised before August 2, 2011. The downgrade could occur if there is no credible or meaningful plan to reduce future deficits. As to state and local governments, S&P has indicated that AAA rated state and local government credits are unaffected by the credit rating uncertainty of the U.S. government and made no mention of reviews of other municipal credits.

Standish's view is that Aaa/AAA rated state and local governments will remain very strong regardless of the Federal government's credit ratings, and that any downgrades of these credits and resulting spread widening would likely be a buying opportunity.

Implications of a Federal Government Default

In the event the U.S. Government's debt ceiling is not raised by August 2, 2011, the Federal government will be unable to issue treasury bonds, notes or bills to provide funding of operations. Tax revenues and cash will continue to flow to the Federal government but will be inadequate to discharge all the payments owed by the Federal government to bondholders, federal employees, beneficiaries for programs such as social security and Medicare, and payments to state and local governments.

The shortage of cash flow arising from an inability of the federal government to issue debt could well lead to delays, most likely short term in nature, of federal government payments to municipal issuers. Below is a brief discussion of our assessment as to how certain classes of municipal bond issuers would be affected, if at all, by a Federal government payment default:

Pre-refunded Bonds: The debt service on pre-refunded bonds is paid by escrowed U.S. Treasury bonds, bonds issued by U.S. agencies or some combination thereof. Depending on how the federal government prioritizes its payments in the event of a shutdown, a Federal government default could cause delays in payment of debt service on Treasury bonds which could lead to a default on the municipal bonds. Any default would be cured once the federal government receives sufficient tax revenues or increases its debt ceiling to enable it to fully fund its operations. Ironically, federal agency bonds, whose debt is paid by underlying mortgages, are unlikely to be directly affected by a federal government default despite the municipal market's preference for Treasury-backed municipals. Standish maintains a strategic underweight to pre refunded bonds due to their relatively low yields.

Grant Anticipation Bonds (GARVEES): Many states receive grant payments from the federal government under highway improvement program, and have issued tax exempt bonds to be repaid from future grant payments. In some cases states have provided back up sources of revenues, usually petroleum-based taxes or vehicle registration fees as a form of credit enhancement. GARVEEs that lack state credit enhancement would be vulnerable to default in the event of a federal default, depending on the timing of debt service payments as well as the duration of a federal default. Standish portfolios have very limited exposure to GARVEEs, and only hold those with what we believe to be adequate state credit enhancement.

Hospitals:¹ Hospital operations and finances are more dependent on federal government payments than most municipal issuers. Medicare, which finances medical care for elderly and which is completely funded by the U.S. government, typically comprises 40 to 45% of a hospital's revenues. Medicaid, which finances medical care for the indigent and which is typically

¹ Source (all data cited in hospital section): 2010 Median Ratios for NonProfit Hospitals and Healthcare Systems, Fitch Ratings.

comprises 10% to 15% of hospital revenues. Therefore, delays in the federal government transfer payments could pressure hospital cash flows. Nevertheless, even the weaker hospital credits, those in the BB and BBB rating categories, generally are able to maintain unrestricted cash and investments equivalent to 76 days (BB rated) and 122 days (BBB rated) of operations on hand. Higher rated hospitals typically have in excess of 180 days (A rated or higher). As a result, while some weaker hospital credits could face a cash squeeze, most would be able to withstand a brief federal slowdown in payments and without undue stress. Standish maintains an overweight position in hospital bonds due to their attractive yields, and focuses holdings on those with strong competitive positions, solid operating margins, and highly liquid balance sheets.

State governments: While state governments typically receive approximately 30% of their revenues² from the federal government, we view the risk of a state defaulting as a result of federal government payment shortfalls as minimal. States have broad revenue bases they can draw upon to pay bond debt service and generally sufficient liquidity to withstand a disruption of payments from the Federal government. Federal payments to states may be delayed as a result of a federal government shutdown; we believe, however, that the federal government will honor its obligations to states in full as cash flow permits. Standish maintains an underweight to state general obligation bonds due to their relatively low yields.

Local governments: Local governments have little dependence on federal funds - approximately 3% of local government revenues come from Washington, DC³. Payment defaults from the Federal government would therefore have very little, if any, effect on local government operations or debt service. Standish maintains an underweight to local general obligation bonds as a consequence of the both relatively low yields and the continued difficult credit environment they face.

Municipal Utilities: Both municipal water and electric utilities derive their revenues from sales and virtually none from the federal government, so their finances would likely be unaffected by Federal government funding problems. Standish maintains an overweight to both water and electric utility bonds in view of their relatively attractive yields and strong credit fundamentals.

Special (Dedicated) Tax Bonds: Many state and local governments issue bonds backed by a specific tax, portion thereof or combination of taxes or fees. These revenues could include taxes on personal income, sales, petroleum products, and other transactions. While these bonds have a narrower revenue base than general obligation bonds, they provide strong bondholder protection as the specified revenues flow directly to bondholders and often with very high coverage. We believe these bonds are therefore well insulated from a federal government default. Standish maintains an overweight to special tax bonds in view of their strong credit characteristics and attractive yields.

Summary

Standish believes the debt ceiling will be raised in a timely fashion to avert a default on Federal government payments. If so, we believe the credit implications for the municipal bond market are limited. Nevertheless, a short term resolution of the debt ceiling may fail to generate a deficit reduction plan strong enough to avert a downgrade of the U.S. government by S&P. In that case, those credits directly linked to the U.S. such as pre-refunded bonds, bonds carrying GNMA/FNMA guaranties and GARVEEs would also likely be downgraded. Other highly rated state and local issuers could be downgraded as well, though in some cases the downgrades could lead to attractive buying opportunities.

Standish portfolios maintain exposures that are largely immune from a federal government downgrade and are positioned to use any dislocation resulting from such an event as an investment opportunity.

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² Source: *State Government Finances Summary: 2009. Published January, 2011*

³ Source: *City Fiscal Conditions, National League of Cities FY2009*



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