

# Fixed Income Insight

## October 24, 2002

### *Municipal Credit Overview and Outlook*

The spillover from the weakening in the economy and the deterioration in corporate earnings has been felt in the municipal credit area, but not to the extent that it has been felt in the corporate bond market. In large part, we believe municipals usually have a broader base of resources and influence to cushion specific sector type credit blows.

**Rating trends still show a more positive picture for municipals than corporate bonds.** While negative rating changes predominate in corporates, municipals have continued to have more overall upgrades than downgrades, albeit at a narrower spread than in previous years:

- ▶ To date, the three rating agencies have twice upgraded the number of credits as they have downgraded (as reported in *Smith's Research and Ratings*).
- ▶ However, the ratio is somewhat less favorable when you look at the changes on a "dollar value" basis. Based on total dollar changes in ratings, the "upgrade to downgrade" ratio is only 1.25 to 1. This is the leanest positive ratio for munis in more than five years.

We are anticipating that the **2003 and 2004 fiscal years will be more challenging for municipal credits** as declining growth in economic activity and income levels emerge. If that happens, budget concerns will become more problematic due to declines in tax revenues and revenue collections for enterprise operations. In our view, one **area of stability for municipals** so far has been the active housing construction market as well as the stable base in property values. This factor has directly benefited the unlimited tax general obligation bonds issued by local governments.

About 50% of this year's record setting new issue volume is being insured by one of the financial guarantee companies. These companies will be the first line of defense to any losses experienced by an insured issuer. As for the insurance companies themselves, the industry is experiencing higher leverage and higher losses, but not at levels that seem precarious to us. We will continue to monitor these companies as more capital may be required by some companies to continue to write new business.

In regards to **specific sector concerns**, bonds associated with healthcare, education, housing and leasing have experienced more downgrades than upgrades this year. GO bonds have shown a mixed outcome with more upgrades than downgrades on an issue-by-issue basis, but a reverse outcome based on the dollar value of total changes (due mostly to some larger credit downgrades, especially related to states). In our opinion, we believe that the following **credit sectors are under the most pressure**: state G.O. bonds, airport special facility bonds, PCR guaranteed by investor owned utilities, multifamily housing projects and tollways (a high percentage of these categories are subject to the Alternate Minimum Tax).



*Guiding Portfolio Strategies*

**MCDONNELL INVESTMENT**  
MANAGEMENT, LLC

# Fixed Income Insight

## October 24, 2002

Sectors that currently appear to be experiencing relatively more positive credit circumstances are related to basic utilities, especially water and sewer, transportation issues paid by specified taxes and existing tollways, local governments in wealthier areas and, to some extent, hospitals. Relative to **specific state concerns**, some states stand out. While nearly all states have been experiencing a slowdown in revenues due to the weaker economy, budget shortfalls appear to be more severe in the following states:

- California
- New Jersey
- New York
- Massachusetts
- Washington
- Oregon
- Illinois
- Wisconsin
- Connecticut
- Ohio

### ***In Summary***

Overall, municipal credit quality is holding up much better than for corporates, especially relative to local governments and basic utility credits. Some across-the-board weakening has been happening in line with the downturn in the economy and the adverse impact on taxes and user charges. However, we believe the more severe problem situations so far have been relegated to the states and private activity supported municipals and project finance start-up situations. If the economy continues to remain soft, state aid payments to local government and some health care providers may diminish and spread credit-related problems to a wider base.

**Richard Ciccarone**  
**Managing Director and Chief Research Officer**  
**McDonnell Investment Management, LLC**

*This commentary is prepared by McDonnell Investment Management, LLC ("MIM") for informational purposes only. The information above is neither investment advice nor a legal opinion. The views expressed by Mr. Ciccarone are as of the date of publication of this piece, and are subject to change without notice. MIM cannot assure that the type of investments discussed above will outperform any other investment strategy in the future, nor can it guarantee that such investments will present the best or an attractive risk-adjusted investment in the future. There are no assurances that any predicted results will actually occur. Past performance is no guarantee of future results.*