

Municipal Insurance and Credit Ratings in the Municipal Market?

With several additional downward revisions to muni insurers, much too numerous to name, not to mention ratings that were yanked – some by design and some by request – liquidity in the municipal market once again became a serious issue. Several major municipal market players either headed to the exits or greatly diminished their participation - UBS has shuttered its institutional muni franchise; Bank of America and Wachovia have both thinned their trading ranks; and let's not forget the biggest guys – Merrill Lynch, Lehman, and Citigroup are all assuming a very cautious posture as it relates to bidding in the secondary and underwriting in the new issue market.

The lack of a realistic “bid side” is really hurting the market, making it much more difficult to raise cash to meet redemptions or engage in bond swaps. This also has a negative impact on daily pricing, as it continues to foster a negative market psychology – even if nothing trades.

While the overall level of interest rates have inched back up into “uncomfortable” territory, investors are once again presented with the unique opportunity to purchase munis (or funds) that are trading on top of – or better than – the levels posted for similar maturity US Treasuries. We aren't at February's levels (gulp) but there is a compelling reason to get excited about munis again

If there is a bright spot in any of this morass, it is the House Financial Services Committee's decision to require rating services to rate municipal securities on the same scale as other fixed income securities, most notably corporate securities. Moody's has already announced an intention to use a combined global scale in the next few months. Since municipal insurance is a corporate rating, the most likely consequence to this decision is a lower than AAA rating for the remaining municipal insurance companies on the global scale. However, when converted to their own underlying ratings on the global or consolidate rating scale a significant number of holdings will receive higher ratings from Moody's, Standard and Poor's, and Fitch and thus a corresponding relative improvement in price.

With the exception of the only remaining Aaa/AAA rated insured bonds (FSA, Assured Guaranty, and, to a much lesser extent, Berkshire) insured municipal bond valuations no longer reflect any “value added” from their burdensome insurance. Underlying creditworthiness is the only measure in today's marketplace. With the vast majority of the monoline insurers having reached their rating nadirs, the only events remaining that would negatively affect the market are the downgrades of MBIA and Ambac to junk status and FSA and/or Assured Guaranty losing their AAA ratings.

All this spells opportunity to the long term holder as underlying high credit quality is recognized and enhanced relative yield is available during the adjustment process. More changes will occur over the next few months and Aquila will update you as it unfolds.

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