WASMER SCHROEDER

Market-Implied Ratings: A Better Benchmark for Internal Ratings

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Introduction

Recent changes to public finance rating criteria used by the credit rating agencies (CRA) have been a topic of active discussion within the municipal market. While rating adjustments are nothing new, the moves have prompted investors to question whether major shifts are taking place in credit quality, as credit risk can affect investment performance and be indicative of new market cycles.

Rating agency actions are not always a telltale sign that credit fundamentals have shifted, even when a bond's rating changes by multiple notches or whole rating categories. In fact, many of the past year's rating modifications resulted from internal adjustments to the criteria used by the agencies to assign ratings. Recognizing the difference between rating changes based on fundamental shifts in credit quality versus those that were driven by policy adjustments requires a proactive research approach.

A discussion with clients is often followed by questions related to our view on the rating agencies and more specifically, how Wasmer Schroeder's (WS) internal ratings stack up to the benchmark ratings that the agencies assign. While the rating agencies are integral to the investment process, we believe that comparative analyses between internal and external ratings have become less relevant, as split bond ratings have grown in prevalence and rating methodologies are more frequently adjusted.

Credit spreads—the market's unwritten rating system

A more telling sign about credit opportunity and risk, in our view, is the study of credit spreads in relation to WS's internal ratings. The table below shows average credit spreads as they relate to the 'AAA' Municipal Market Data (MMD) Scale and their respective market-implied rating equivalents. For example, market levels indicate that the average yield pickup for a 10-year municipal bond in the 'BBB' rating category is 80 basis points (bps) over the generic 'AAA' rated municipal bond with the same maturity. This means that generally, we would want to earn at least 80 bps more than a generic 'AAA' rated municipal bond for taking on the credit risk of a 'BBB' rated issuer. However, a 'BBB' rated issuer that is trading "wider" or "tighter" than the average credit spread—indicating that the market-implied rating is lower or higher than the agency benchmark—could signal a shift in credit fundamentals that should be evaluated alongside internal research. The comparison of our internal rating to the one that is indicated by the credit spread at which the bond is trading is a critical input for our investment professionals when making relative value decisions. The application of this concept can be seen in the following case study on the Public Lighting Authority of Detroit (PLA).

Implied Credit Ratings Based on Credit Spreads

Average 10-Year Spread (Bps)	Market-Implied Rating Category
+16	AA
+38	A
+80	BBB

*03/20/19; Source: 'AAA' MMD Scale

Case study: Public Lighting Authority of Detroit

In February 2019, Standard & Poor's (S&P) lowered PLA's 'A-' rating by four notches to 'BB+'. Actions of this direction and magnitude are commonly referred to as "super-downgrades" and can be particularly alarming when they result in so-called "junk" ratings for bonds that previously held investment-grade ratings. Although this action signaled a material decline in credit quality, the Authority's underlying credit fundamentals were actually unchanged. Instead, the downgrade was prompted by S&P's new criteria for rating special tax bonds, which now incorporated the agency's view on the creditworthiness of Detroit, the city's ties to the Authority's governance, and pledged revenues of the utility.

For investors who were unfamiliar with this credit story or the new rating criteria, the downgrade may have triggered unnecessary trading. However, WS had identified the issuer as being vulnerable to rating pressure from criteria changes. In the following table, we summarize our analysis of the issuer's market-implied rating, relative to our internal rating, before and after the rating action.

Before Super Downgrade (Nov 2018)

S&P Rating	WS Rating	Market-Implied Rating
A-	BBB+	A

Reasons for WS Rating

- Longstanding name in our more credit-focused mandates with credit fundamentals and security features that were more in line with a 'BBB+' rating than the 'A-' rating by S&P.
- Vulnerability to rating pressure under S&P's new criteria was high and could be multiple notches.
- Current trading levels were rich to the internal evaluation but indicative of the sophisticated buyer base for the trade and conviction in the credit story.
- Default risk remained unlikely and exposure continued to be appropriate for WS's credit-focused accounts, despite the rating risk.

After Super Downgrade (Feb 2019)

S&P Rating	WS Rating	Market-Implied Rating
BB+	BBB+	BBB+

Market Response

- Bonds were downgraded multiple notches, which WS considered to be a likely event.
- Initial market spreads following the 4-notch downgrade were unchanged, signaling that the buyer base was unphased by this criteria-driven downgrade.
- Spreads stabilized at wider levels to reflect the updated bond rating, implying that the market viewed this as a 'BBB+' rated name.
- The additional credit spread was in line with our internal evaluation, confirming that investors were being adequately compensated for the credit risk factors that we believed were present.

Conclusion

Rating agencies continue to be critical contributors to the investment process—however, their relevance as a comparison to internal ratings has diminished in our opinion, because of the rising number of split bond ratings and the frequency with which agencies make changes to their rating methodologies. Instead, we believe that market-implied ratings are the better benchmark for internal ratings. Credit spreads reflect the market's assessment of investor information in the aggregate, incorporating a broad opinion of the situations that are value-add opportunities and the situations that should be avoided.

Loren McDougall
Senior Credit Analyst

Loren McDougall is a Senior Credit Analyst at Wasmer Schroeder and is responsible for tax exempt and taxable municipal credit research, focusing on low investment grade and below investment grade credit. She is a member of the firm's Municipal Credit Committee..

Loren earned her BS in Finance from Florida Gulf Coast University. She is a member of the National Federation of Municipal Analysts, the Southern Municipal Finance Society, the CFA Institute, and the CFA Society of Naples, where she served as President in 2017-2018. Loren is a frequent guest speaker at FGCU's Lutgert College of Business.