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City Manager's Office

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson

SUBJECT: **STANDARD & POOR'S US RATING DOWNGRADE AND RECENT MARKET VOLATILITY**

DATE: August 9, 2011

Approved [signature] Date 8/9/11

INFORMATION

On August 5, 2011, the Standard & Poor's rating agency downgraded the long-term sovereign credit rating of the United States, one notch, to AA+ from AAA with a negative outlook. Fitch Ratings affirmed its AAA rating with a stable outlook while Moody's Investor Service maintained its Aaa rating but placed the United States under a negative outlook. It's also important to note that Standard & Poor's affirmed the short-term rating of the United States at A-1+, which is the highest possible short-term rating.

Standard &Poor's downgrade rationale cited that the deficit reduction efforts *"falls short of what is necessary to stabilize the government's medium term debt dynamics,"* and that the downgrade reflects their view that, *"the effectiveness, stability, and predictability of American policy-making and political institutions have weakened."*

Given recent significant market volatility, it is important to note that market commentators primarily attribute the volatility in the equity (stock) and bond markets to three primary factors; (1) concerns of European debt; (2) slower growth projections for US economic output; and (3) the unprecedented downgrade by S&P of the United States government long-term debt.

While it appears that there will be no immediate impact to the City's credit ratings from the recent Standard & Poor's downgrade (meaning the City's ratings will likely not be downgraded as a result of the S&P sovereign downgrade), there are potential residual impacts to the City and to the national/local economy stemming from the three primary factors noted above.

Following is a listing of potential General Fund impacts stemming from the S&P downgrade of long-term US sovereign debt, slower US economic growth, and constrained federal spending which is prompting investors shift in strategy and talk of a potential double-dip recession (please note that there may also be exposure to other City programs such as Housing or Transportation due to constrained federal spending):

- Due to the factors noted above, there has been a recent "flight to quality" in the bond market (meaning investors are currently "uneasy" and shifting their investment strategy by "selling off" in the stock/equity markets and investing those proceeds in US and municipal government bonds). This recent trend has resulted in even further reductions in the continued historic lows in interest rates. This trend in interest rates has the following impact on the City:
    - Interest income revenue projected for the general fund – staff believes that General Fund interest earnings of $110,000 projected in the 2011-12 Adopted Budget are still achievable due to the conservative budget forecast based on continued low market rates.
    - To the extent that the interest rates continue at the lower rates or drop even further, the interest expense will be lower to the City for interest the City pays on its variable rate debt and any planned near-term future debt.
        - The City currently has approximately $900 million in variable rate debt outstanding. Due to the unprecedented low interest rate environment, the average rate the City paid for the fiscal year ended June 30, 2011, was approximately 23 basis points (.23%). As interest rates have continued to decline, our interest rates we paid last week on this variable rate debt ranged between .05% and .14%.
        - Two debt issuances are anticipated for Council approval in the fall; (1) General Obligation (GO) Bonds - the remaining $9.0 million of GO bonds approved by the voters and plans to refund some existing GO bonds due to projected economic savings as a result of lower interest rates; and (2) the 2011B Airport Revenue Bonds. The recent flight to quality in the US Treasury market has maintained the already low historic rates.
        - As with all City debt issuances, market rates will be evaluated at the time of issuance.
- In the event the US economy is subjected to recessionary forces or a potential "Double Dip" recession, there are other considerations that may affect the City's fiscal health. Below are some key areas that staff will continue to monitor:
    - In the event of any potential further "tightening" of US or State funding to local government, staff has reviewed the FY 2011-12 general fund budget. Revenues from State and Federal sources, including funding received as part of the American Recovery and Reinvestment Act, are currently a small proportion of total General Fund revenues. As part of the 2011-12 Adopted Budget, Revenues from the State are budgeted at $14.5 million, of which $9 million is funded through Tobacco Settlement payments. Federal revenues are currently budgeted at $21.2 million for 2011-12.

- In the event the economy is subjected to recessionary forces, the City's two primary general fund revenue sources (property tax and sales tax) are economically sensitive. As part of the 2011-12 Adopted Budget, General Fund revenue projections for Property Tax receipts and Sales Tax receipts account for 26% and 18.4%, respectively. It is important to note that the 2011-12 Adopted Budget includes conservative revenue growth estimates of a 2.1% increase for Property Tax and a 2.0% increase for Sales Tax.

- In addition to potential impacts to the City's General Fund revenues from a potential "Double Dip" recession and further erosion in the stock/equity markets, the City has potential budgetary exposure through its Retirement contributions starting with 2012-13. In the event slower US growth impacts corporate profits and investors continue to shift their investment strategy for the stock market to the bond market, the resulting decline in equity prices will be reflected in the annual investment results for both Retirement Plans for 2011-12.

Staff will continue to monitor the recent market volatility and economic climate and report back to Council as warranted. In addition, as part of the issuance of the 2011 General Obligation Bonds, presentations will be made to all three rating agencies in mid-September. These presentations will be developed utilizing current local economic and budgetary data and will offer the City its first rating opportunity post the recent sovereign downgrade. As is customary, staff will report out to Council the results of ratings affixed to the new General Obligation bond issuance.

SCOTT P. JOHNSON
Director, Finance

This memorandum has been coordinated with the City Manager's Budget Office. For questions please contact Scott P. Johnson, Director of Finance at 535-7001.