**S&P Cuts Illinois Credit Rating**

* MARK PETERS

Standard & Poor's Ratings Services dropped the credit rating for Illinois Friday, putting it on track to have the lowest rating among U.S. states.

The decision by S&P follows the collapse earlier this month of a proposal in the Illinois legislature to address the deepest public-pension shortfall in the nation. Negotiations continue, but there remains no agreement around how to fill an estimated $95 billion pension hole. S&P in its downgrade cited the legislature's "poor track record" on the issue and the likelihood of legal challenges if a plan passes.

"We simply cannot afford continued downgrades at a time when we urgently need to restore stability and balance to the state's fiscal climate," said Rep. Tom Cross, Illinois House Republican leader, in a statement.

The downgrade of the state's bond rating to A- from A puts Illinois on par with California. However, S&P has a negative outlook for Illinois, while its outlook for California is positive. Moody's Investors Service already gives Illinois the nation's lowest rating, while Fitch Ratings has a lower rating on California, but recently put the rating for Illinois on watch for a possible downgrade.

Even with its low rating, Illinois has been able to access capital markets at relatively low interest rates. In the meantime, state legislators have been unable to reach agreement on how to put the pension for state workers and public school teachers, among others, on a path to being properly funded.

S&P estimates the pension system in the coming year will see assets fall to 39% of future obligations. Gov. Pat Quinn, a Democrat, has made pension reform a top issue, but is facing stiff opposition to his plan from public-sector unions because it includes cuts in benefits for retirees.

# Bond Insurer Sues Credit-Rating Agencies

## ACA's Is Second Filing in Two Weeks Over Crisis-Era Calls

Bond insurer ACA Financial Guaranty Corp. sued the major credit-rating firms for allegedly falsely representing that their letter-grade ratings were free of conflicts of interest.

The lawsuit is the second fraud lawsuit filed against the firms in as many weeks and comes as [the Justice Department's lawsuit against Standard & Poor's Ratings Services is gathering steam](http://online.wsj.com/article/SB10001424127887323993804578611791957758294.html). The liquidators of two Bear Stearns Cos. hedge funds [sued S&P,](http://online.wsj.com/article/SB10001424127887323740804578597883074252160.html) [Moody's Investors Service](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=MCO) and Fitch Ratings last week [MCO +1.30%](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=MCO?mod=inlineTicker) on nearly identical claims.

The ACA lawsuit, like the Bear Stearns case, appears to be timed to beat the statute of limitations for fraud cases in New York state, which is six years, say lawyers not involved in the case. The three major rating firms began their downgrades of hundreds of mortgage-linked securities in July 2007.

ACA sued S&P, Moody's and Fitch in New York State Supreme Court on Tuesday, seeking $359 million in damages, according to a filing. The filing, like the Bear Stearns filing, is a four-page summons and notice, not a full-fledged complaint.

"In carrying out their fraud," the filing alleges, the rating firms "falsely represented that relevant credit ratings reflected their true current opinion regarding the credit risks" the securities presented. The rating firms "falsely represented that the ratings provided were objective, independent, and uninfluenced by any conflicts of interest," the filing alleges.

Spokesman for S&P and Fitch both said the allegations were without merit and the companies would defend themselves vigorously. A spokesman for Moody's and a lawyer representing ACA didn't immediately respond to requests for comment.

Spokesmen for Moody's and Fitch didn't immediately respond to requests for comment. A lawyer representing ACA didn't immediately respond to a request for comment.

ACA is tangled in another crisis-era lawsuit.

An ACA executive is expected to take the stand [in the civil trial of former](http://online.wsj.com/article/SB10001424127887323309404578611973465307956.html) [Goldman Sachs Group](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=GS) Inc. executive Fabrice Tourre [GS -0.19%](http://online.wsj.com/public/quotes/main.html?type=djn&symbol=GS?mod=inlineTicker) that has captured Wall Street's attention this summer. The Securities and Exchange Commission claims Mr. Tourre lied to investors about the risk of a crisis-era deal, a charge he denies.

ACA acted as the portfolio-selection agent on that deal.

ACA's lawsuit against the credit-rating firms comes as the U.S. federal government's case against S&P is gathering momentum. A U.S. district judge ruled Tuesday that the government's fraud case against S&P could proceed, rejecting S&P's request that he throw out the entire lawsuit.

# Yielding to New Realities for Government Bonds

## Short-Term Outlook Could Prove Jarring; a Testing Time

* RICHARD BARLEY

The mood swings in the bond market this year have been violent.

From February to May, a rally in U.S. Treasurys, German bunds and U.K. gilts saw German yields hit record lows; from May to September, a selloff pushed U.S. and U.K. yields to two-year highs. Now, the Federal Reserve's decision not to reduce its bond purchases has driven another move lower for yields.

Eventually, yields should head higher again. But in the short term the outlook is decidedly murky.

Bond yields are well off their recent highs: 10-year Treasury yields peaked near 3% in early September and now stand at 2.62%. That rally has come even as risk appetite has shown signs of recovery, in demand for emerging-market bonds, for instance. Some investors believe this fall in yields is a head fake: With signs that a global recovery is under way, albeit gradually, yields should rise.

![[image]]()

Some of the clearest risks are political, but may prove transitory. In Europe, with the Italian government in chaos after the resignation of five ministers from former Premier Silvio Berlusconi's party, German Bunds are likely to find support. But the European Central Bank's bond-purchase pledge may help limit the fallout.

In the U.S., the spotlight is on the political gridlock around budget and debt-ceiling talks. Nerves may well build in October, but ultimately many think a resolution will be found. If stocks fell sharply, that would focus political minds, Citigroup thinks. Therefore, enthusiasm for Treasurys might prove short-lived.

Bigger concerns might revolve around the economy and bond-market positioning, however. One fear is that the rise in U.S. yields over the summer brought forward some housing-market activity; the data later this year might prove weak, potentially influencing the Federal Reserve.

In Europe, the exit from recession is unlikely to lead to a swift rebound in growth, and the European Central Bank may yet face pressure to turn its dovish talk into reality.

Technical factors in the bond markets could also lead to lower yields in the short term. The rise in rates has made it more expensive to bet against bonds, and the Fed's surprise has raised the bar for taking short positions.

Moreover, with yield curves steeper, investors who are leery of government bonds may miss out on returns generated by the roll-down effect.

This is where prices of existing bonds rise as they move closer to their maturities. Technically, Treasury yields have room to fall to 2.45%, according to Royal Bank of Scotland.

Lower Treasury yields will pull global yields along with them. But investors will still have to watch domestic data closely, particularly in the U.K., where economic indicators have been extremely strong. Continued outperformance by the U.K. economy is likely to mean continued underperformance by gilts.

For investors who want to position for lower or stable yields, Treasurys and bunds look the better bet.

**Nothing bankers like more than a steepening yield curve**

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Financial stocks were the highest performing sector in the S&P 500 in May, as the month comes to a close.  The Financial Select Sector SPDR Fund  [XLF](http://marketwatch.com/investing/stock/XLF) , which tracks financial stocks in the S&P 500, was up 7.5% for the month, compared to half that in the broader market in the same period. In contrast, the U.S. Treasury bond yield curve has  have steepened, which analysts say is a good sign for bank profits.

“The steepening is definitely good for banks, as banks these days make their money on the net income margin,” said Larry McDonald, [author](http://www.lawrencegmcdonald.com/) of Colossal Failure of Common Sense. “The steeper the curve, the bigger the spread between where they borrow and where they lend.”

Simply speaking, the steeper the yield curve, the more likely banks will lend.



“As Treasury yields advance they tend to do so at a faster pace across the yield spectrum,” said Andrew Wilkinson, chief economic strategist at Miller Tabak & Co. LLC.  “There is nothing investors welcome more in terms of earnings prospects for financial names than a steeper yield curve.”

The chart shows the Financial Select Sector SPDR, contrasted with Treasury bonds yield curves,which has recovered to its highest price since 2008.

“There is nothing bankers like to do more than borrow-short and lend-long in the face of a steepening yield curve,” said Wilkinson. “And we doubt that such appetite will be hindered by the highest reading of consumer confidence in nearly five years.”

Fear of euro-zone risk has also played a part in financials stocks doing well.

“One of the biggest reasons financials are doing well, is that systemic risk in Europe is 70% [lower] than it was last year,” said McDonald.

For the month of May, major financial stocks were up double-digits:

[Morgan Stanley](http://www.marketwatch.com/companies/Morgan_Stanley?lc=int_mb_1001) [MS](http://marketwatch.com/investing/stock/MS) was up 18.5%. Citigroup Inc. [C](http://marketwatch.com/investing/stock/C) was up 13.5%.  J.P. Morgan Chase & Co. [JPM](http://marketwatch.com/investing/stock/JPM) was up 13%.  Bank of America Corp. [BAC](http://marketwatch.com/investing/stock/BAC) was up 13%. Goldman Sachs Group Inc. [GS](http://marketwatch.com/investing/stock/GS) was up 13%.

But it’s not all about the yield curve.  Industry watchers say banks have other restraints holding them back from lending and making more profits.

“Despite the yield curve steepening, Fannie and Freddie, the FHFA, Basel III and Dodd-Frank legislation have a lot of impact on whether banks lend,” said McDonald. Banks have to hold more reserves today than before due to new legislation rules since the financial crisis.

**Inverted Yield Curve Signals Lower Inflation, Not Recession**

* ERIN MCCARTHY OF DOW JONES NEWSWIRES

NEW YORK --Emerging-market bulls, don't fret just yet. Economic wonders Brazil and India are still likely to grow, despite speculation lately about coming recession in the developing world.

In recent weeks, yield curves in Brazil and India have inverted, a signal in the developed world that a recession is on its way. An inverted yield curve in U.S. Treasurys correctly predicted the recent Great Recession. Some are now warning of a similar fate for emerging markets.

But not so fast. To the emerging world, inverted yield curves might be a vote of confidence, analysts say.

Some investors are "trying to extrapolate from how developed markets' fixed-income curves react or what they signal into emerging markets, which is not necessarily the case," said Paul Biszko, strategist at RBC Capital Markets. "Lower long-end yields tend to be a sign that investors are becoming more comfortable...with the longer-term dynamics of a sovereign."

Ultimately, the curves are a truer reflection of inflation risks and the effectiveness of monetary policy. The front of the curve is higher because of the ongoing rate hike cycle central banks are undertaking, in response to higher inflation risks in the near term, analysts say. Brazil has hiked its key interest rate four times this year to a towering 12.25%, while India's central bank has increased interest rates 10 times in the last 16 months to 7.5%.

But the flattening of the curves suggest that emerging-market central banks are starting to win the battle against inflation, said Michael Roche, analyst at MFGlobal.

"If they weren't, financial market participants would continue to demand a higher inflation premium in long-term domestic bond yields," he added.

"There's definitely increasingly strong demand for longer-dated, emerging-market yields," RBC's Mr. Biszko said.

Though analysts don't expect a recession in these economies, growth is already more modest than in past booms, and the effectiveness of the tightening cycle will likely keep that dynamic in place.

With U.S. economic data recently weakening and China's pace of growth slowing, markets are "keying off this global phenomenon that's going on," said John Peta, portfolio manager at Acadian Asset Management. As central banks raise rates, short maturities' yields are rising in response, but longer maturities' yields are falling "as markets realize there is a slowdown coming, and therefore inflation is less of a worry."