

# FIVE STATES ON DOWNGRADE WATCH

## JANNEY FIXED INCOME STRATEGY

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- Moody's placed five Aaa rated states on watch for downgrade.
- Ten Aaa rated states are not on watch, with Moody's noting that ratings are resilient to a one notch US rating downgrade.
- If the US debt crisis is resolved, as we expect, these states may still be vulnerable to rating declines, depending on impact of federal budget cuts.

### FIVE STATES UNDER REVIEW

The Washington showdown over the debt ceiling washed into the municipal markets when Moody's announced they were placing five Aaa rated states on watch for downgrade. Using a set of six criteria, Moody's reviewed the fifteen states it rates as Aaa, and identified Maryland, New Mexico, South Carolina, Tennessee and Virginia as states which would likely be downgraded if the US Aaa rating was lowered; it is not automatic, since Moody's will review each state in more depth, before lowering the boom. The good news is that ten other Aaa rated states, (Alaska, Delaware, Georgia, Indiana, Iowa, Missouri, North Carolina, Texas, Utah and Vermont) are not under review, with Moody's noting their ratings are resilient to a one notch US downgrade.

Moody's considered the totality of factors, focusing on three specific to exposure to the federal government and three of a more macroeconomic and financial nature. Presumably, a state with many federal employees and exposure to Medicaid, for example, might not make the review list if it had large general fund balances and low non-federal government employment volatility. Although the six factors noted are important, Moody's will consider other metrics and information for any final determination.

### Potential Downgrade Considers Six Major Factors

Factors	Maryland	New Mexico	South Carolina	Tennessee	Virginia
<b>General Financial Factors</b>					
Employment Sensitivity to US Economic Performance	Above Average	Below Average	Average	Above Average	Above Average
Capital Markets (Variable Rate Exposure)	Low	High	High	High	Low
Fund Balances as Percent of Revenue	Below Average	Above Average	Below Average	Below Average	Below Average
<b>Federal Government Related Factors</b>					
Federal Employment as Percent of Total State Employment	Above Average	Above Average	Below Average	Above Average	Above Average
Federal Procurement Contracts as Percent of State GDP	Above Average	Above Average	Above Average	Average	Above Average
Medicaid as Percent of State Expenditures	Average	Above Average	Above Average	Above Average	Below Average
<b>S&amp;P/Fitch Ratings</b>	AAA/AAA	AA+/NR	AA+/AAA	AAA/AAA	AAA/AAA

Source: Moody's, Janney Fixed Income Strategy

**ALAN SCHANKEL**  
Managing Director  
215 665 6088  
aschankel@janney.com

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## US DEBT CEILING RESOLUTION MAY NOT REDUCE DOWNGRADE POTENTIAL

If Congress and the administration get through the debt ceiling crisis, which we believe is highly likely, that does not necessarily diminish the potential for downgrades. Depending on short-term and long-term details of any budget agreements, Moody's and the other rating agencies could downgrade US debt. Even if US debt remains at Aaa, significant spending cuts enacted as part of any deficit reduction plan could negatively impact federal employment, Medicaid payments and other federal spending which benefit state and municipal government.

We observed no immediate changes in trading levels for bonds of these states after the release of Moody's report. An indicator of relative trading levels is a comparison of yields for a specific issuer's bonds with a AAA benchmark yield, such as the Thomson Reuters MMD scale, published daily and updated during the day. Maryland and Virginia practically define AAA yields used in calculating the benchmark. For most of this year Virginia yields have been 2 bps below the MMD ten year benchmark yield, while Maryland's ten year yield equaled the MMD yield all year.

### Basis Point Spread Over 10 Year AAA Benchmark

	MD	NM	SC	TN	VA
1/3/2011	0	24	2	4	-2
4/1/2011	0	24	3	1	-2
7/19/2011	0	18	1	1	0

Source: Thomson Reuters MMD, Janney Fixed Income Strategy

## CONCLUSION

The states identified by Moody's would likely be downgraded if the US rating dropped, and could face a lower rating even if the debt ceiling issue is favorably resolved or if the US rating remains unchanged. Thus far there has been no observable impact on trading levels for these states, but that could change over time, particularly if any or all are downgraded.

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