

# NJ BONDS OVERSOLD

JANNEY FIXED INCOME STRATEGY

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Rising spreads for New Jersey bonds have put the state's GO and appropriation backed bonds into oversold territory.

## SUMMARY

- Economic underperformance and high levels of debt and pension liabilities have increased NJ credit spreads from 33 bps to 78 bps in the past year.
- With downgrades from Moody's and S&P behind, we believe an opportune entry point for purchase of NJ debt has been reached.
- State economy is again growing, although at a slower pace than nations average.
- CDS spreads indicate declining credit risk.

## GARDENING FOR VALUE IN NEW JERSEY DEBT

Moody's late April downgrade of New Jersey's rating, from Aa2 to Aa3 was not unexpected. S&P dropped their rating from AA to AA- in February, and Fitch revised its outlook on the state's AA rating to negative the day of the Moody's cut. Last week the state was in the market with \$600 million Transportation Trust bonds, (A1/A+/AA-), and the relatively high yields of the deal generated attention. The thirty year maturity, initially priced with a 5.65% yield, received enough demand to allow underwriters to drop the yield 18 bps to 5.47%, but comparison to another deal in the market on the same day brings the impact of the Garden State's travails into sharp focus. Drexel University (A3/A/NR), recently downgraded by both Moody's and S&P, carried a 5.45% yield in the thirty year maturity. Drexel is a fine school and its creditworthiness is not in question, but it's difficult to understand why an issuer such as the Transportation Trust, backed by the state's contractual promise to pay debt service (subject to legislative appropriation) would not receive a stronger market reception (lower yield) than a lower rated and recently downgraded private university.

### NJ Transportation Trust New Issue Spreads Have Widened

Sale Date	Rating	Maturity	Yield	MMD	Spread
10/13/2010	Aa3/AA-/AA-	12/1/2024	3.97%	2.82%	115 bps
5/3/2011	A1/A+/AA-	6/1/2025	5.00%	3.48%	152 bps

Sources: Thomson MMD; Janney Fixed Income Strategy

Comparison of yields from a May 3, 2011 issue with those of the prior NJ Transportation Trust issue from October 2010, pre-downgrades, shows spreads have risen. Spread is the basis point differential between a bond's yield, and the yield of a same maturity benchmark, in this case the Municipal Market Data AAA. Spreads for this issuer's fourteen year maturity widened by 37 basis points – from 115 bps to 152 bps. New Jersey is paying a price for past financial missteps. An additional 37 bps in interest expense works out to about \$2.2 million per year on \$600 million.

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Garden State Economic Indicators Are Mixed

Comparative Indicators	NJ	National	PA	NY
Unemployment Rate (3/11)	9.3%	8.8%	7.8%	8.0%
Economic Activity Change YoY (2/11)	0.9%	2.8%	4.3%	1.9%
Tax Revenue Increase (Q4-10 vs Q4-09)	8.1%	7.8%	6.9%	19.0%
Pension and Debt as Percent of GDP	13.2%	NA	4.1%	4.4%
Per Capita Income (2008)	\$51,358	\$40,208	\$40,140	\$48,753
Per Capita GDP (2008)	\$54,549	\$46,142	\$43,872	\$58,542

Sources: Janney Fixed Income Strategy; Labor Dept; Commerce Dept; Moody's; Rockefeller Inst of Government

ROCKY ROAD TO RECOVERY

It's a challenging time for New Jersey. The state is recovering from the recession more slowly than most others, with the March 2011 unemployment rate at 9.3%, well above the 8.8% national rate. As the national economy was adding jobs, NJ job growth was flat. Ironically, the main culprit behind NJ's recent employment woes is cuts in government job rolls. Facing lower revenues and stubborn budget deficits, state and municipal leaders slashed payrolls, trading short term pain (perhaps long term if you are the one laid off) for long term gains in fiscal stability. Although the state's output is among the strongest, with GDP per capita well above the national average, economic activity has been slower to recover than that of other states post recession.

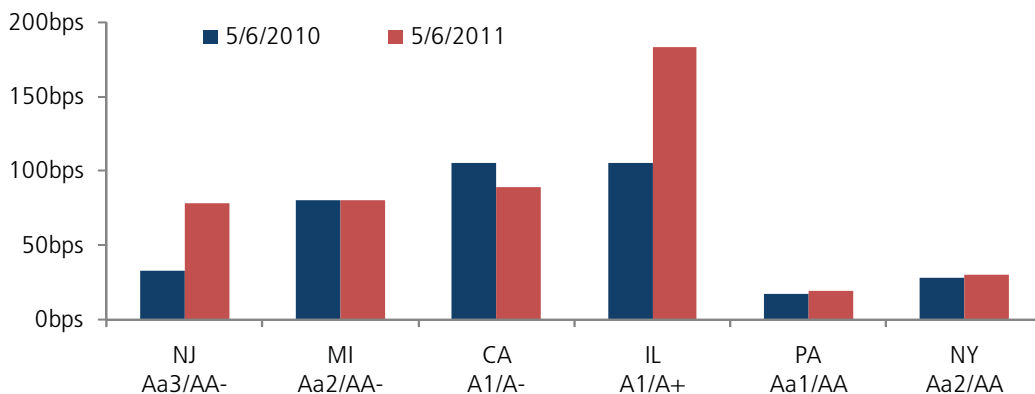
The good news is that New Jersey is a wealthy state, with a diverse economy. Per capita income is the second highest in the country after Connecticut. Tax revenue is recovering, with income and sales taxes growing by 8% 4Q2010 YoY. A recent report from Rutgers' Economic Advisory Service projects that state economic output will grow at a 1.9% rate in the coming decade compared to 2.7% nationally. They also project growth in employment, personal income and population, although lagging the national pace.

Governor Chris Christie has had the reins of government for about sixteen months, and his efforts to pare back spending have been well noted in local and national headlines. Unlike California's governor, for example, the New Jersey chief executive enjoys considerable power and flexibility in enacting change. The governor can reduce or delay certain spending with no legislative approval. One area of spending cutbacks has been aid to local municipalities and school districts, which helps the state's budget gap, but pressures the credit quality of local issuers.

A recent Moody's report listed New Jersey as ninth among states in the ratio of debt and underfunded pension liabilities to GDP. The 13.2% level puts Jersey well above states such as New York (4.4%) and Pennsylvania (4.1%). NJ's pension funding challenge has been further exacerbated by the state's failure to make all of required pension contributions in recent years. On the positive side (from bondholders perspective) the governor is seeking significant reforms in pensions and Other Post Employment Benefits (OPEB) such as health insurance. Christie has proposed rolling back a 9% 2001 increase in benefits, and is seeking larger contributions to the plans from employees.

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NJ Ten Year Debt Spreads Have Underperformed Those of Most States



Sources: Janney Fixed Income Strategy; Thomson MMD

### THE SWINGING PENDULUM

New Jersey is paying a significant price for past financial extravagance. We noted earlier the yield differential for last week's issue compared to six months earlier. The graph of state GO bond spreads, on the previous page, shows that New Jersey's spread to AAA benchmark yields has doubled in the past year, and is closer to rates paid by troubled states such as California, with its budget disarray and Michigan, with its crippled rust belt economy than neighboring Pennsylvania and New York. Given the current administration's push to rein in spending, and the strong underlying economy of the state, the price pendulum may have swung too far. Although immediate spread tightening is not likely, we think the market has absorbed most of the bad news, and that over time, finances will improve with the economy, and GO bond spreads will narrow.

#### NJ CDS Levels are Narrowing, Indicating Falling Credit Risk



Sources: Janney Fixed Income Strategy; CMA

A view of the market's perception of credit risk is available through credit default swap (CDS) levels. Since the outcry of municipal credit concerns, highlighted by Meredith Whitney's appearance on a Sixty Minutes segment in December titled Day of Reckoning (which also featured Governor Christie), CDS levels have dropped. From a high of 223 bps in January, New Jersey CDS have dropped to 128 bps, meaning that institutional investors, the primary participants in the CDS market, need to pay \$12,800 per year to protect against default on \$1 million New Jersey GO bonds, well below January's \$22,300 level.

### CONCLUSION

We believe that current yield levels for New Jersey GO and appropriation backed issues offer investor value, and that in the next twelve months, New Jersey issues will generally outperform national benchmarks. To be sure, the state faces continued challenges, but management has the willingness and ability to improve finances. As always, we advocate a robust diversification approach to municipal portfolio structure, but investors with little New Jersey exposure may consider this an appropriate entry point. Post downgrade, both Moody's and S&P have a stable outlook on the state (Fitch has a negative outlook and may lower to AA- in coming months). The financial future of New Jersey is more positive than has been the case for a while.

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