

MOODY'S RATING CHANGES

JANNEY FIXED INCOME STRATEGY

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MOODY'S ANNOUNCED IT WILL BEGIN RECALIBRATING ITS RATING METHODOLOGY, INCREASING THE CREDIT RATINGS OF MANY STATE AND MUNICIPAL ISSUERS

INTRODUCTION

- These anticipated rating increases do not indicate improved credit quality, but rather level the playing field between municipal credits and non-municipal credits.
- Moody's shift more closely reflects the generally strong quality of state and municipal general obligation issuers.
- The process will begin in mid-April, taking about four weeks to complete.

Yesterday Moody's announced it will recalibrate municipal bond ratings, applying the global rating scale used for non-municipal bond issuers, a change which will raise the ratings for many investment grade municipal bonds. We've noted before that municipal bonds are typically of higher credit quality than like rated corporate bonds. Default statistics provided by all three rating agencies certainly support this premise. Moody's may also be acknowledging the political pressure to update rating criteria. Senate Banking Committee Chairman Christopher Dodd's most recent financial regulatory reform proposal, released Monday, contains a provision requiring the SEC to develop rules to compel rating agencies to use a uniform system for rating all bond issuers. The timing of Moody's announcement is likely no coincidence. S&P has maintained it already incorporates a uniform approach to ratings while Fitch is reviewing the issue.

Beginning in mid-April, and lasting over a four week period, Moody's will announce changes to its rated municipal debt, impacting many of its 70,000 ratings. Since 1918, Moody's has used a separate rating scale for municipals that emphasizes "distance to distress rather than expected loss." By comparison the global scale measures "expected loss as the product of default probability and the loss which would occur following a default." This shift is key. Not only have munis experienced few defaults, but when a default occurs, recovery rates are stronger than those of corporate issuers. Orange County, California's bankruptcy in 1994 was the largest municipal bankruptcy in history, but when the dust settled, bondholders were made whole, although county taxpayers are still paying the price. The same can't be said for General Motors.

MOODY'S INVESTMENT GRADE CATEGORIES

Aaa	Aa1	A1	Baa1
	Aa2	A2	Baa2
	Aa3	A3	Baa3

WILL ALL MOODY'S RATINGS CHANGE?

Moody's adjustments will vary by both rating and sector, with GO's seeing the biggest change. Of course Aaa rated issues can't go higher, but depending on sector, bonds in the Aa range may be bumped a notch - Aa3 to Aa2 for example - and A rated issues could move up 2 steps. Low investment grade general obligation issues should see the most significant adjustments, as many as 3 steps. For example, if the rating on California moves up three levels, the rating of the only state rated below A would go from Baa1 to A1. The following information contains general guidelines, and may not apply in every case.

- General obligation, water and sewer, municipal utility districts and distribution only utilities are most likely to see upward adjustments with current Aa's moving one notch higher, A's two steps and Baa's as many as three steps.

Depending on sector, Moody's ratings may be adjusted higher by two or even three notches.

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- Special tax, mass transit, non-utility enterprises, TIFs and Garvees currently rated in the Baa1 to Aa1 range may see one step improvements.
- Public universities and related foundations currently rated in the investment grade range could see one step bumps.
- Health care, housing, private K-12 and charter schools, private universities and non-profits, transportation and other infrastructure enterprises, power generating facilities, state revolving funds, bond banks and federal leases will likely see no change.
- Issues rated below investment grade, Ba, B, Caa etc. will not see any rating changes as a result of recalibration.

In general, the closer an issuer's credit characteristics are to tax supported general obligation bonds, the larger the impact. The more businesslike enterprises such as hospitals and private schools will see fewer, if any, adjustments.

MARKET IMPACT

There is much discussion about how these upgrades will affect issuers and investors.

- Issuance of taxable Build America Bonds, which are structured to attract a wider investing audience than traditional tax frees, may increase. Currently, BABs rated Aa3 and above make up the majority of larger BABs issuers. Borrowers which see rating increases from A to Aa categories will give more consideration to BABs. If BABs issuance increases further, supply of traditional tax frees is likely to decrease.
- Although these rating increases do not reflect actual credit quality improvement, the perception of improvement, particularly from retail investors, should lead to marginal trading level increases for many of the bonds with increased ratings. For example, money managers whose investment guidelines include an A or better requirement may consider issues which are upgraded from Baa to A categories.
- With more A and Aa rated bonds, we could see a commoditization effect, as was experienced with Aaa insured issues pre-2008, before the credit deterioration of most bond insurers. Conceptually if more bonds are rated Aa, they could become more interchangeable.
- There will be an adjustment period for benchmarks. Market commentators, traders and many investors benchmark bond values based on published yields from Municipal Market Data (MMD), Municipal Market Advisors (MMA), Bloomberg, the Bond Buyer and others. Will the yields in a AAA curve change as former Aa rated bonds become Aaa? Will that impact the validity of historical comparisons? We'll learn more as the picture develops.

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CONCLUSIONS

It remains to be seen if Fitch and more importantly S&P will enact any changes. This action on Moody's part is welcome and overdue. Investors may be gratified to see higher ratings on future monthly statements, and marketability of some municipal issues will see marginal improvements. Investors who focus on high quality should consider raising their standards a notch – perhaps Aa2 minimum rather than Aa3 for example. Of course this decision will vary with each investor. In any case, six months or a year from now, after the market has absorbed this change, this will be little more than an interesting news story from March, but Moody's action is an important improvement to municipal markets, more accurately reflecting the generally strong credit quality of state and municipal general obligation issuers.

ANALYST CERTIFICATION

We, Alan Schankel and Tom Kozlik, the Primarily Responsible Analysts for this report, hereby certify that all of the views expressed in this report accurately reflect our personal views about any and all of the subject sectors, industries, securities, and issuers. No part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

DEFINITION OF OUTLOOKS

Positive: Janney FIS believes there are apparent factors which point towards improving issuer or sector credit quality which may result in potential credit ratings upgrades

Stable: Janney FIS believes there are factors which point towards stable issuer or sector credit quality which are unlikely to result in either potential credit ratings upgrades or downgrades.

Cautious: Janney FIS believes there are factors which introduce the potential for declines in issuer or sector credit quality that may result in potential credit ratings downgrades.

Negative: Janney FIS believes there are factors which point towards weakening in issuer credit quality that will likely result in credit ratings downgrades.

DEFINITION OF RATINGS

Overweight: Janney FIS expects the target asset class or sector to outperform the comparable benchmark (below) in its asset class in terms of total return

Marketweight: Janney FIS expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return

Underweight: Janney FIS expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return

BENCHMARKS

Asset Classes: Janney FIS ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclay's U.S. Aggregate Bond Market Index" as a benchmark.

Treasuries: Janney FIS ratings employ the "Barclay's U.S. Treasury Index" as a benchmark.

Agencies: Janney FIS ratings employ the "Barclay's U.S. Agency Index" as a benchmark.

Mortgages: Janney FIS ratings employ the "Barclay's U.S. MBS Index" as a benchmark.

Investment Grade Credit: Janney FIS ratings employ the "Barclay's U.S. Credit Index" as a benchmark.

High Yield Credit: Janney FIS ratings employ "Barclay's U.S. Corporate High Yield Index" as a benchmark.

Municipals: Janney FIS ratings employ the "Barclay's Municipal Bond Index" as a benchmark.

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