

# Moody's Weekly Credit Outlook

March 2, 2009

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### Moody's Teleconference

Moody's will host a teleconference on **Monday, March 2 at 10:00AM EST / 15:00 GMT / 16:00 CET** featuring the authors of the following articles:

- Not Much Credit in U.S. for Bank CAP Funding
- Blueprint for U.S. Healthcare Reform Weighs on Insurers
- RBS and Lloyds are the first for UK's Asset Protection Scheme
- Newspapers: Don't Print That Obit Yet
- Auto Maker Restructuring Plans Affect ABS Differently
- Accounting: Five Key 10-K Disclosures for Fixed Income Investors

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## News & Analysis

### *Credit implications of recent worldwide news events*

## U.S. Financial Institutions

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### The U.S. Housing Plan Is Positive for Banks

On balance, we expect the U.S. housing plan to be positive for banks, especially when examined in the broader context of other government initiatives, because it has the potential of attenuating the fall in housing-related bank assets that have proved toxic for banks' balance sheets during this crisis. A question that remains, however, is whether the government can set these incentives at the right levels (i.e., amounts of money that will be granted to participants) in order to encourage a critical mass of loan refinancing and mortgage payment modifications that will stop the current downward spiral. That said, even if the program does not reach the 7 to 9 million homeowners targeted by the plan, anything that can help reduce foreclosures and, at the same time, reduce the inventory of houses for sale in the market, is a positive development for banks.

Loosening refinancing rules for mortgages currently owned or backed by Fannie Mae and Freddie Mac will allow a greater number of borrowers to refinance at a lower rate than would otherwise happen. While this flexibility will not directly affect banks - as these loans are owned or guaranteed by Fannie Mae and Freddie Mac - banks will nonetheless indirectly benefit if the housing market stabilizes earlier than expected, and if the initiative reduces the number of foreclosures.

Loan modifications will have an impact if they are enacted quickly and with scale. This will depend, by and large, on the economics of the incentives. Servicers and banks will want to minimize losses and will be cherry-picking among their foreclosure or loan modification options to choose those that will be most profitable (or least costly). Therefore, we anticipate that servicers and banks will compare the cost of loan modification vs. foreclosure to determine which route maximizes value for them. However, their perspective will differ.

Servicers continue to accrue service fees when a mortgage is in foreclosure and, when the house is sold, their fee is paid from the net proceeds. The servicer is paid before investors. As such, servicers may have less of an incentive to initiate loan modifications than the mortgage holder. We thus believe that loan modifications are more likely to be initiated by the mortgage holder.

Banks, as mortgage holders, have access to the home, which they hold as collateral, and will want to assess how much they would lose by seizing and re-selling the home and compare that with the loss potential from a modified mortgage.

The establishment of an insurance-like reserve of up to \$10 billion is a complementary feature of the plan that may be particularly efficient in the current context of falling house prices. In assessing their options, there is a risk that, even where the economics of a modified loan make sense, a servicer or a bank might opt for foreclosure because of fear that the home value will fall in the near future and increase the probability of default. Thanks to this fund, however, holders of mortgages modified under the plan would be provided with a payment linked to the decline in the home price index, which acts as a further incentive to undertake loan modifications.

We expect that government agencies have surveyed banks and servicers to ensure that the mix of incentives is sufficient to ensure a behavioral change in relation to loan modifications. We suspect they obtained very specific data on the 6 million mortgages that are at risk and crafted the incentives where they could have the greatest impact in order to tip the balance in favor of mortgage retention and modification as opposed to foreclosure. But this remains to be seen.

The program creates lower monthly mortgage payments as an incentive for borrowers. While this may be a sufficient incentive, borrowers must be willing to continue to make monthly mortgage payments on a home that is worth less than the mortgage. We consider that to be a distinct challenge.

On the downside, the plan introduces some uncertainty for banks that are Financial Stability Plan recipients, as the government expressed its intention to require them to undertake systematic loan modifications if they fall into certain categories (to be determined later in guidelines expected to be published on March 4, 2009). This could force banks to modify loans where this alternative would not minimize losses. This would be harmful to their credit because these banks' capital levels have already been depleted.

Additionally, many have criticized the fact that judges will be given the power to force a loan modification during bankruptcy procedures. Current bankruptcy laws exempt the mortgage on a person's primary residence from rules allowing debts to be written down, and some fear that allowing primary mortgage principal to be written down by a judge will create an incentive for people to declare bankruptcy and drive up interest rates by increasing the financial exposure of lenders. Although we agree that this is another source of uncertainty, it does have the advantage of acting as a stick alongside the carrot of incentive fees. It might work, but there is a risk that banks could incur substantial losses because they likely hold material amounts of conforming loans in their portfolio. The impact of cram downs may be muted by restrictions placed on bankruptcy judges or limitations on the types of mortgage products that qualify for a cram down (e.g., sub-prime loans only).

Support provided to Fannie Mae and Freddie Mac attempts to attack the problem of increasing mortgage rates from two sides: buying Fannie's and Freddie's debt helps reduce their cost of funding; while the purchase of assets that both Fannie and Freddie securitize helps create demand for these securities and contributes to a reduction of the premium demanded by investors. Both initiatives should help reduce the interest rates that these GSEs must demand from borrowers to be profitable.

Overall, the plan is a positive, but it may not by itself be sufficient to curb the current home depreciation trend. That is why we believe that it must be looked at from the broader perspective of the other initiatives that have been undertaken, as what will ultimately save the housing market will be an economic turnaround that sustains employment and allows borrowers to pay their mortgages.

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## **Not Much Credit for Bank CAP Funding**

In conjunction with its Financial Stability Plan, the U.S. Treasury announced the terms and conditions of its Capital Assistance Program (CAP). The purpose of CAP is to restore confidence in the banking system by ensuring that banks have sufficient capital to absorb losses resulting from a prolonged, severe economic downturn and to resume lending activities. Following stress tests to evaluate the capital position of the major U.S. banks, funds will be available through CAP to provide additional cushion should it be needed.

Under CAP, funding will be available through the issuance of mandatory convertible preferred stock (MCPS), which is described below and compared to the existing Troubled Asset Relief Program (TARP) Preferred Securities. The issuance of the MCPS is not likely to have a meaningful impact on our view of a bank's capital position because many banks with hybrids have already reached their 25% hybrid equity credit limit.

We view the MCPS as a form of contingent capital where we would give benefit to the equity only when it is issued, either automatically in seven years or at the bank's option earlier. Similar to our views on TARP preferreds, we consider the MCPS to be temporary funding, where there is incentive to replace the securities with private capital or eventually redeem them through public sources. For banks that refinance the MCPS prior to equity conversion, an important consideration will be how the transition is made from a government-supported capital structure to one that is again more market based.

Features	Mandatory Convertible Preferreds	TARP Preferreds
Size (% of Risk-Weighted Assets or RWAs)	No less than 1% of RWAs; maximum is 2% of RWAs plus any issued to redeem outstanding TARP Preferreds.	No less than 1% of RWAs; maximum is the lesser of \$25 billion or 3% or RWAs.
Maturity	7 years	Perpetual
Conversion to Equity	At any time by the bank with automatic conversion in year 7 at a 10% discount to the stock price prevailing prior to February 9, 2009	Not Applicable
Redemption, subject to Regulatory Approval	At any time, with common stock proceeds of no less than 25% of the issue price or through additions to retained earnings	At any time (as revised by the American Recovery and Reinvestment Act of 2009)
Dividend Rate	9% increasing to 20% in 6 months if shareholders have not increased necessary authorized shares; cumulative if unpaid	5% in the first 5 years and 9% thereafter; cumulative if unpaid
Dividend Stopper/Share Repurchase Restrictions	Yes	Same
Ranking	Senior to common stock and pari passu with existing preferred shares	Same
Executive Compensation Limits/Other Requirements	Yes	Yes
Warrants	Yes	Yes
Regulatory Treatment	Tier 1	Tier 1

Subject to regulatory approval and certain program limits, banks can request capital under CAP in addition to any outstanding TARP preferreds. Banks will also have the option to exchange their existing TARP Preferreds for the MCPS. The main difference between the two securities is the equity conversion feature in the MCPS, which results in the issuance of equity in no later than seven years, assuming that the preferreds remain outstanding for the duration. This provides banks with equity, if and when needed, but also provides the flexibility to refinance if their fortunes improve.

From an equity credit perspective, prior to conversion, we view the MCPS to be in line with the Basket B treatment (75% debt and 25% equity) of the TARP Preferreds, pending a final decision by our relevant committee. The possibility of a future equity infusion provides a bank with financial flexibility, but this benefit is potentially offset by early redemption of the preferred itself. Following conversion, we would then give full benefit to the equity outstanding.

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## Limited Scope of Extended Tax Loss Carry-Back for U.S. Banks

In the process leading to the passage of the U.S. Government's stimulus package, government representatives decided in extremis to withdraw a much-hoped-for tax proposal. This proposal would have allowed money-losing financial institutions and other firms to go back five years, instead of two under current tax rules, to seek tax refunds against taxes paid on past profits. The final version of the bill signed by the president only permitted this extended carry-back for 2008 losses incurred by small businesses.

This is a disappointment for U.S. banks, as the five-year carry-back period could have resulted in significant refunds of taxes paid in prior years, boosting capital and liquidity, and helped banks avoid deferred tax asset (DTA) write-downs.

Additionally, this outcome impacts our approach to assessing banks' capital adequacy levels. An integral element in our ratings process includes the stress testing of a bank's assets and earnings, and the resultant effects on the bank's capital base. As part of this exercise, we tax-effect expected write-downs on loans and securities at the standard corporate tax rate of 35%. However, given the current economic crisis, it is becoming less likely that certain banks will have sufficient taxable income within the carry-back or carry-forward time constraints to utilize these tax losses. Consequently, we will potentially no longer tax-effect these write-downs. Not affecting these expected write-downs will put additional stress on bank capital levels. The decision to tax-effect losses will be made on a case-by-case basis and consider the potential for future profitability and the size and nature of current DTAs.

**Tax Refunds from Loss Carry-backs Less Likely for U.S. Banks.** Corporations are currently permitted to carry-back current year tax losses against the preceding two years taxable income. Current year losses essentially offset profits in the previous years and taxes paid on those profits are refunded to the company. In regards to the U.S. banking sector, the proposed extension of the carry-back period to five years would have increased the probability that banks could claim large refunds of taxes paid in previous years.

With only a two-year carry-back period, banks are unlikely to see significant tax refunds. For example, assume book losses are equal to tax losses. In this case, losses recognized in 2008 can be carried back to 2006 and 2007. The industry was highly profitable in 2006, but in 2007 profitability fell dramatically. Losses recognized in 2009 can only be carried back against 2007 and 2008, periods in which the banks may not have had any taxable income.

**Recoverability of Deferred Tax Assets at Risk.** If a corporation's current year tax loss exceeds the previous two years taxable income, the losses can also be carried forward to offset future taxable income (the carry-forward period generally ranges from five to 20 years, depending on the specific circumstances). In this situation, a company records a DTA, which is utilized in future periods against taxable income. However, if the company's anticipated future income is not achieved, the tax benefit generated by previous losses cannot be utilized and the related DTA is written-off with a negative impact on net income and capital.

Due to the uncertainty regarding the near-term future profitability of the U.S. banking system, it is unclear if banks will be able to fully utilize their DTA. The five-year carry-back period would have made banks less reliant on future profitability to utilize their tax losses. As such, we consider bank DTAs to be vulnerable to write-downs. Several banks that we rate – including Citizens Republic Bancorp and Independent Bank Corporation – have already either fully or partially written-off their DTA.

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## Blueprint for U.S. Healthcare Reform Weighs on Insurers

Two Medicare Advantage (MA) related announcements this week could harm the credit quality of some healthcare insurers. Downward pressure on ratings, which could be experienced as early as this year, will depend on resolution of 2010 MA reimbursement levels, the outlook for membership enrollment, and the companies' reliance on MA for earnings.

It came as no surprise that the budget blueprint released by the Obama Administration this week calls for reducing government reimbursement levels for MA plans beginning in 2012, to help fund healthcare reform. As a candidate, President Obama's healthcare reform proposal cited a need to "eliminate excessive subsidies to Medicare Advantage plans and pay them the same amount it would cost to treat the same patients under regular Medicare." Any cuts to Medicare Advantage reimbursement rates will lead insurers to reduce benefit levels in the MA plans they offer. As a result, we would expect MA membership to decline as seniors elect to move back to the traditional government Medicare program. This is especially troubling, since many insurers had been looking to MA as a key source of growth, to offset declining commercial membership in the current challenging economic environment. Healthcare insurers with a large proportion of their business in MA plans will be impacted the most. These include Humana, HealthSpring, and Coventry.

Interestingly, the budget announcement came a few days after the Centers for Medicare and Medicaid Services (CMS) released their preliminary Medicare Advantage rates for 2010. The proposed rate levels were considerably lower than what analysts and healthcare insurers expected, prompting a press release from Humana stating that "the rates as announced would have a significant adverse impact on 2010 premiums and benefits for Medicare Advantage members if these rates become final." It is not clear if the proposed rate levels were influenced by the administration's goal of reducing Medicare Advantage reimbursements, but, in any event, this is a major concern for the sector.

It was clear that under an Obama Administration, MA plans would come under pressure; however, most industry observers expected a more gradual impact. Given recent developments and the current administration's targeting of these plans for reform, insurers will need to re-examine the long-term viability and profitability of this business.

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## EMEA Financial Institutions

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### RBS and Lloyds are the First for U.K.'s Asset Protection Scheme

On Thursday February 26th, 2009, the HM Treasury released further details of the previously announced Asset Protection Scheme as well as the participation of Royal Bank of Scotland (RBS) in the scheme. Lloyds Banking Group also announced Friday that it's in advanced talks with the government regarding its intention to join the Scheme, but a final agreement has not been reached.

In our recent rating actions on RBS and Lloyds, we specifically noted that the C- BFSRs of RBS and Bank of Scotland (the lead bank of HBOS, recently acquired by Lloyds) remained on review for possible downgrade in order for us to assess the impact of the Asset Protection Scheme. These reviews are likely to be concluded in the coming weeks when further details regarding exactly which assets will be covered by the Scheme are available for each particular institution. Given the cap on potential losses as a result of the Scheme, it is likely that these ratings will be confirmed at their current level.

The aim of the Scheme is to cap the potential losses that the banks are facing especially with regard to structured credit and commercial property loans. By lowering the level of uncertainty that exists around these potential losses as well as the impact of the Scheme on risk-weighted assets (thereby increasing regulatory capital ratios), the UK government hopes to kick-start lending into the troubled UK economy. Indeed, as a condition to participate in the Scheme, the banks will be required to make certain commitments, including on employee remuneration and lending volumes—for example RBS will legally commit to additional lending of GBP25 billion, split between residential mortgages (GBP9 billion) and business lending (GBP16 billion).

Of the assets that HM Treasury expects to be covered under the Scheme, we believe that the most important for RBS and Lloyds will include structured credit assets and commercial property loans—however the Scheme allows for other assets to be included such as leveraged loans, corporate loans and residential mortgages. The Scheme is structured so that the banks still have a first loss exposure (calculated on a case-by-case basis); losses beyond the first loss amount are split between HM Treasury (90%) and the bank (10%). The fee payable for participation in the Scheme can be paid either in cash, or as in the case of RBS, by the issuance of capital instruments.

We believe that the key benefit of the Asset Protection Scheme will be protection from the potentially very high losses that could materialize from the pools of troubled assets on the balance sheets of UK banks. In the case of RBS, GBP325 billion of assets will be covered, thus even if credit costs exceed the first-loss position of GBP19.5 billion, exposure to further economic losses is unlikely to have an impact on the bank's current BFSR, especially as the Scheme will cover the most problematic assets of the bank.

We believe that the Scheme reduces many of the uncertainties relating to the level of potential losses for UK banks, especially in the current environment where more fluid economic scenarios make the predictability of future loss amounts particularly difficult. We further note that even if banks do not initially participate in the Scheme, the availability of this insurance vehicle for losses is a credit positive for all UK banks and especially for those with currently higher levels of potential losses.

It is interesting to note also that the UK Scheme is similar to the U.S. Government Eligible Asset Guarantee program offered to Citigroup and Bank of America in that losses exceeding a first loss amount will be shared by the bank and the government at the same 10% and 90% proportion.

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## **U.K. Makes B&B's LTII Coupons Deferrable**

The UK Treasury announced last week that effective February 20, 2009, principal and interest payments on Bradford & Bingley's (B&B) dated subordinated debt (LTII) are deferrable. Market reaction was understandably very negative with CDS spreads on subordinated bonds widening across the whole sector. However, the broader market implication of this action by the Treasury for LTII notes of other banks, and indeed for the sanctity of debt contracts terms in the UK in general, was clarified in a letter by the Financial Services Secretary to the Treasury on February 25, 2009 stating that this deferral option was only possible under the Banking (Special Provisions) Act of 2008 under which B&B was nationalized and the act is no longer in effect. Importantly, the letter adds that Tripartite's powers and procedures under the new Banking Act of 2009 do "not provide for modification of terms and conditions of contracts (including for subordinated debt instruments) to the same extent as the Banking (Special Provisions) Act of 2008."

We believe that this clarification by the government is positive and significant as it should alleviate some of the uncertainty regarding the contractual terms of subordinated debt indentures that came into question after the government announcement on B&B's LTII notes last week. Our ratings on such bonds take into account both their ranking in the capital structure and the fact that their coupons are not deferrable.

For B&B, we note that the new deferral option will not have rating implications for our current Ca ratings of their LTII notes. The ratings were downgraded from Ba3 to Ca at the time of nationalization (September 29, 2008) reflecting the exclusion of these notes from the government guarantee and our expectation of a very limited recovery for holders of these instruments.

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## Assicurazioni Generali Places Senior Debt

Assicurazioni Generali (Aa3 IFSR / A1 senior debt; stable), the Italian-headquartered global insurance group, successfully placed a EUR 750m 5 year senior bond at the end of last week, marking the first major public debt issuance from a European insurer for several months. We do not necessarily expect that this issue heralds a flood of similar European insurance debt issuances, but it shows that insurers may be able to access debt funding at more favorable rates than we thought likely in current markets.

From an operational perspective, most European insurers' generally maintain very strong liquidity profiles, and hence their necessity to raise debt to support liquidity is limited: premium cashflows provide good sustained cash income, and policyholder call options are generally limited or, where they do exist, come with substantial exit penalties. In terms of debt refinancing requirements, most issuance in recent years (2005-8) has been through perpetual hybrid securities with non-call periods (at least 5, often 10 years), meaning that many securities only have first call dates in 2010 and onwards. Some senior debt has shorter maturity profiles, although we understand that the majority of European insurance groups have limited volumes of debt maturing in 2009 and 2010. In addition, for those groups with maturing debt, the option to refinance internally / deleverage may be attractive, depending on the quantum involved and availability of cash.

However, the Generali issue appears to indicate that capital markets are, perhaps temporarily, open to issuance from highly-rated European insurers, and in addition those groups that decide to opt for refinancing may find good levels of investor.

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## Italian Government Strengthens Bank Capital - A Little

The Italian Government published the details of hybrid bonds last week with the aim of providing additional capital to listed Italian banks. While we view higher capital levels favorably, the amount was small, hence the limited impact on the overall capital adequacy of the Italian banking system. Additionally, while the new capital may be accepted as counting towards Core Tier 1 capital by the Italian regulators, we view its equity characteristics as limited in our calculations of tangible common equity. As a result, these instruments are unlikely to have a significant impact on the ratings of Italian banks.

The fresh capital is part of the support measures introduced in October, which were passed into law in December 2008. The features of these bonds make them relatively strong as loss absorption and deferral of interests. Given, however, that the gradually increasing call price and significant coupon step-up (from 25 basis points in 2010 to 750 basis points in 2039) are incentives to call the bonds, we do not consider them to be permanent and will likely assign relatively limited equity credit (as per our hybrid securities methodology) in the calculation of tangible common equity to risk-weighted assets.

The amount set aside by the government is around €10 billion to €12 billion, which is modest compared to the more than €100 billion Tier 1 capital of rated banks. The measures taken by the Italian government are far more limited in terms of amount compared to other major European banking systems, and involve the issuance of instruments with generally less equity-like characteristics. In other countries, governments have subscribed either common equity in banks (such as in the UK), or instruments with far stronger equity characteristic such as in the Netherlands (75% equity credit) or Switzerland (100% equity credit).

That said, Italian banks have been far less exposed to the credit market crisis, and have seen only very limited write-downs on financial instruments. The need for additional capital is therefore far more limited than is the case in other major European banking systems, which, in some cases, have suffered severe losses. In Italy, these measures will simply provide a slight improvement to capital adequacy ratios, and make the banks better placed to continue lending activities while maintaining some buffer against potential losses, in a deteriorating economic environment.

While these measures should prove beneficial to the extent that they reinforce confidence in the Italian banking system and facilitate continued normal operations, they are unlikely to lead to rating upgrades given their small scale, the limited equity characteristics of the instruments, and the fact that the initiative is intended to be temporary. Improved capital adequacy will help to counterbalance the potential for downward pressure on bank financial strength ratings, which may be exerted by deteriorating future profitability. This reflects the difficult operating environment and the likely increasing need for impairments on loan portfolios in the next 12 to 18 months.

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## Use of IAS 39 in Asia Challenges Comparability Across Banks

With the Asia-Pacific reporting season underway, a key consideration in analyzing bank financial statements is the use of the "look back" option as permitted under amendments made in October to International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*. This option allows banks to backdate as far as July 1, 2008 the value of the assets that they decided to reclassify. We believe that this amendment challenges the comparability of financial statements across banks globally, and, based on our preliminary findings, this has indeed been the case in Asia, especially the Philippines.

In countries that have adopted International Financial Reporting Standards (IFRS), including Australia, Hong Kong, New Zealand, Malaysia, the Philippines, Singapore and Taiwan, regulators amended their corresponding local implementation guidance shortly after the changes instituted by the International Accounting Standards Board (IASB).

Reviews of the financial disclosures since the changes were made show that, with the exception of Philippine, banks have so far made fairly limited use of the "look back" option. However, as only a handful of banks have reported financial information for the July to December 2009 period in Australia, Hong Kong and New Zealand, it may be too early to conclude that the option's use is truly limited.

Banks that reclassify financial instruments are required by IFRS 7, *Financial Instruments: Disclosures*, to provide detailed information on their reclassifications and the reason for the reclassifications in order for a third party to be able to compare the use and impact of this decision across banks.

Based on our preliminary analysis, roughly half of the Philippines' publicly listed banks availed themselves of the "look back" option. Some banks were particularly aggressive, reclassifying as much as two-thirds of their investment securities portfolio. The main benefit from the retroactive reclassification is that it has inflated reported capital, especially for those banks that chose to backdate their reclassification to a time prior to the dislocations of global credit markets in September. Our assessment reveals that two banks chose to backdate their reclassification as of July, one as of August, while the others as of September.

However, based on their unaudited filings for 3Q08, actual disclosure practices varied considerably, and mostly fell short of what would be needed to ensure comparability across banks.

Based on these considerations, we find that Philippine banks' use of the "look back" option as permitted under amendment IAS 39 challenges the comparability of financial reports across banks, especially given the unevenness in disclosure practices and the relatively aggressive use of the option by a few banks.

For the purpose of ratings, and as stated in an earlier report on this issue,<sup>1</sup> we may adjust financials for those banks that use this particular accounting forbearance. Further, we also consider lowering the financial reporting transparency score in our BFSR methodology of those banks that we perceive to be using aggressive accounting principles without a solid economic rationale. While the use of the IAS 39 look-back option does not represent an egregious case of financial reporting opacity (thanks to its disclosure under IFRS 7), it can nonetheless be misleading for investors and credit professionals.

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## Corporates

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### Newspapers: Don't Print that Obit Yet

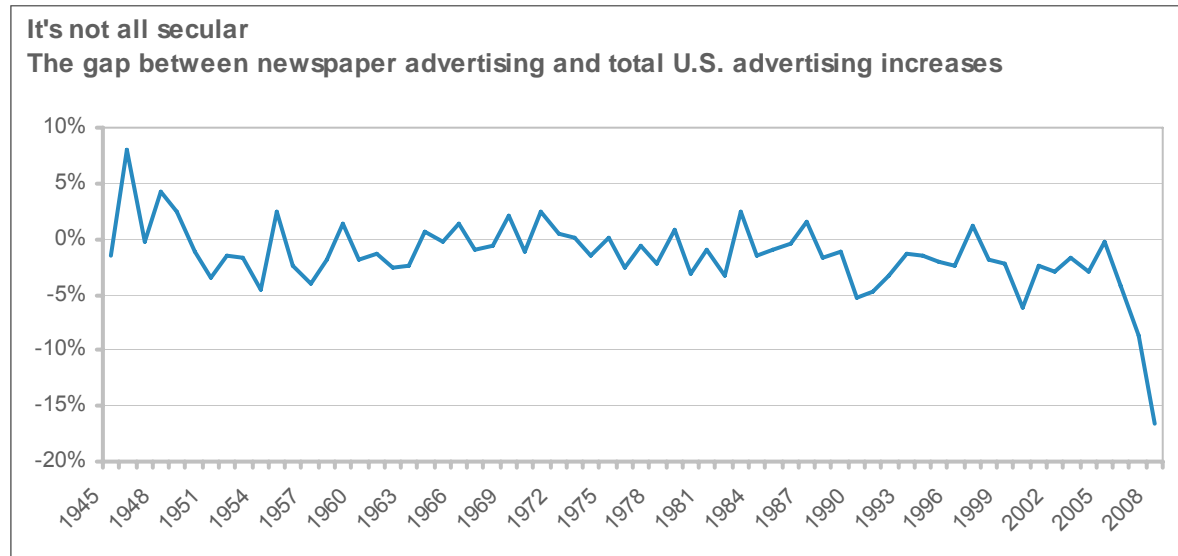
While two major newspapers filed for bankruptcy last week and another daily folded, concerns that the industry is on the verge of collapse are overdone. Instead, two outcomes are likely. First, a dramatic de-leveraging of the industry will occur, through bankruptcies or through debt reduction funded from cash flow. And, newsroom cuts will cause some damage to the content that is the heart of the industry's value – creating more risk of losing readers.

Last week brought the bankruptcy filings of *The Journal Register* and the Philadelphia Newspaper partnership (owner of *The Philadelphia Inquirer*). Hearst said it might shut *The San Francisco Chronicle* and E.W. Scripps published the last edition of *The Rocky Mountain News*. Amid all of this, we downgraded Gannett to speculative-grade on Thursday.

While the newspapers are in the midst of a severe advertising slump and face a host of other issues, they still provide the nation with news, particularly in local markets. And most have an underlying business that remains profitable, even if those profits will continue to decline. For example, the average EBITDA margin for the eight newspaper publishers we rate was 16.8% in 2008, with MediaNews the lowest at around 7.7%.

It is important to look beyond the headlines when news breaks about the demise of a newspaper. We've noticed that recent newspaper shutdowns have largely been concentrated in markets that can no longer support two newspapers (Denver and Cincinnati), but that can support at least one. In other cities, showdowns with unions and high leverage are prompting management to take aggressive actions (Philadelphia, Minneapolis, San Francisco, Newark). Some companies have too much debt.

<sup>1</sup> "Use of the "Look-Back" Option of Amended IAS 39 Challenges Comparability Across Banks", November 2008 (112393).



The gap between growth in newspaper advertising and the overall U.S. ad market always widens in economic downturns. The newspaper recession that began in 2006 has been particularly painful for the industry (see chart) because major newspaper advertisers such as auto dealers and retailers have felt the brunt of the consumer spending slowdown. The growing newspaper-U.S. market advertising gap over the past 15 to 20 years is a good proxy for the negative secular trend, and we expect this to continue.

However, we doubt pure secular issues can explain the dramatic widening of the gap in 2008 (and projected for 2009) and suspect at least part of it will reverse once the economy recovers. Our fundamental credit outlook for the newspaper industry for 2009 remains negative, and we believe a deep and prolonged downturn would surely produce more casualties. But we don't believe that the demise of a large swath of newspapers across the U.S. is imminent.

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### Higher U.S. Cigarette Taxes Will Cause Modest Credit Deterioration

Significantly higher federal excise taxes (FET) that take effect on April 1 will have a meaningful effect on cigarette consumption rates in the U.S. as retail prices rise more than 15%. The increase in the FET to approximately \$1.00 from 39¢ a pack will fund the Children's Health Insurance Program Reauthorization Act of 2009 (CHIP). Tobacco company credit quality will deteriorate modestly, but investment-grade ratings will hold, assuming price inelasticity models are reliable predictors in a severe recession.

Declining volumes are not a new challenge for cigarette manufacturers that have faced secular declines of between 2-3% for decades. Current tobacco consumption is at levels similar to the 1940s as consumers have become more aware of the dangers of smoking and as social stigmas and smoking bans have influenced behavior. Significant price hikes from taxes and other government payments have also reduced smoking incidence.

Further tax hikes are likely as federal and state governments struggle to balance their budgets. Ironically, the government's interest in maintaining a viable industry is closely aligned with the manufacturers' given the reliance on tax proceeds to buoy state coffers. Already contributing over \$35 billion in excise tax, sales tax, and tobacco settlement payments, the highly profitable tobacco industry is a major source of new funding. The desire to reduce smoking provides a social context as the need to fund new social programs provides a fiscal impetus. Pushing tax rates too high, however, will reduce cash inflows to federal, state and local governments sorely in need of revenue.

The impact on credit quality, while modest, will depend on the reliability of historic price elasticity models. We know that the additional taxes will be passed to the consumer and will greatly reduce cigarette consumption and revenue generation for the manufacturers. The question will be whether or not the severe U.S. recession will increase the effect.

It is estimated that each 10% increase in price decreases volumes in the U.S. by approximately 4%. This implies that based on an average price per pack of approximately \$4.35, the higher FET could result in a volume decline of at least 6%. The average price of a package of cigarettes is likely to rise above \$5.00 with nearly 45% of the retail price going towards state and federal taxes.

Historic models suggest that volumes will recover over time following these large price increases. This occurred as recently as 2008, when volume declines moderated in the second half, following sharper declines earlier in the year due to higher state excise taxes as well as price increases for certain brands.

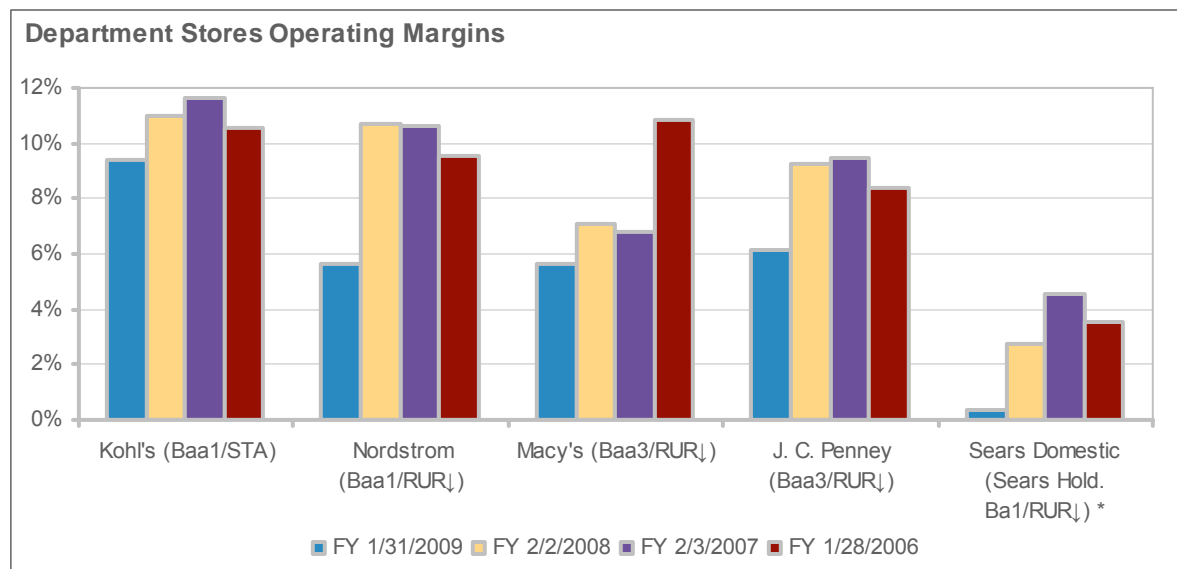
Other historic precedent provides some support for the view that the industry is resilient to these sudden price shocks. In 1998, implementation of the Master Settlement Agreement (MSA) resulted in an over 30% increase in the average price per pack, causing volumes to decline well above trend line at a rate of over 8% for over a year before rebounding as smoking incidence equilibrium was reached – that is, marginal smokers quit and regular smokers adapted to new pricing level.

The future of the tobacco industry depends on factors largely out of the control of the companies. But we believe the volume dislocation brought about by the FET increase will be short-lived and that companies will be modestly impacted. Any material deviation from these expectations could pressure ratings. See our recently published U.S. Tobacco Industry Outlook for more detailed analysis.

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## Department Store Earnings Take It on the Chin

Last week, the five largest U.S. department store chains reported earnings. Our concern that heavy promotions would have a sizable negative impact on earnings was born out. On average, operating income declined by over 35% for fiscal year 2008 when compared to 2007 with average operating margin declining by over 200 bps. To add to the pain, some chains provided 2009 earnings guidance that showed expectations for a further decline in operating income of nearly 35%. Ouch.



This level of earnings decline and the outlook for a prolonged economic downturn does not bode well for a mature sector that entered the recession with fundamentals already eroding due to competitive pressures. Clearly, we expect the credit quality of these five companies to erode in the year ahead, with four of the five companies currently on review for possible downgrade.

But what does this mean for the size of the sector going forward? Does the level of operating income decline foreshadow department stores beginning to shed underperforming stores, thereby increasing the level by which overall industry sales erode? And what will this potentially cost department stores?

We believe that the ongoing decline in department stores' operating income will lead to some companies closing underperforming stores. It has already led to a sizable decline in the amount of capital spent on new store openings, relocations, and remodels, as well as to liquidation of certain smaller players such as Meryn's. Material store closures in addition to low consumer spending within the current weak economic environment will lead to an increase in the level of sales erosion within the sector. For the period 2000-7, department store sales declined 2% due to competitive pressures. But the weak economy in 2008 caused sales to decline over 4% in a single year. Based upon the 2009 sales guidance provided by a few companies, we believe sales will decline more than 6% in 2009. Sizable store closures will only add to this decline.

Should department store chains choose to shed their underperforming stores, it will result in the taking of additional charges. Most department store leases are longer-term and many of the chains own a sizable portion of their store base — so such store closures may prove costly. However, the cost of the store closures may be offset by a boost to earnings realized by shedding money-losing stores. At this point, it is difficult to estimate the potential impact to earnings from store closings. However, it is fairly certain that the level of decline across the sector will accelerate.

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## Middle East Investment Will Improve Petrochemical Credit

Middle Eastern countries continue to invest in global petrochemical companies in an effort to expand their global market position and acquire technology. In refinancing the companies they purchase, they tend to delever them and improve their credit quality. The announcement last week that International Petroleum Investment Company (IPIC), which is wholly owned by the government of the Emirate of Abu Dhabi, intends to acquire NOVA Chemicals for \$6 per share is another step in that process. IPIC can be viewed as a white knight for NOVA (B2 CFR), which was facing the triple threat of weak financial performance, sizable debt maturities (\$250 million in April) and a very difficult banking environment. If the transaction is approved by Canadian regulators, management will need to revise NOVA's credit facility and plan for another \$200 million of debt maturities in 2010. We believe that IPIC will need to invest some additional equity capital into NOVA to ensure that lenders and potential bondholders are comfortable with NOVA's ability to weather the current downturn.

NOVA's bonds are likely to remain outstanding and the existing management will continue to operate the business. Any upgrade of NOVA's ratings will depend upon the amount of additional equity support from IPIC, along with the long-term benefit as a government related issuer<sup>2</sup> (Abu Dhabi is rated Aa2).

In the current weak global economic environment, our outlook for petrochemical companies became more negative due to the expectation of slower demand growth in developing countries over the next year or two along with new capacity coming on-stream over the next two to three years. In this environment, we believe that Middle Eastern countries will continue to acquire attractive international assets and petrochemical technology.

Saudi Arabia, mainly through SABIC, has been at the forefront of this acquisition trend. They originally purchased DSM's petrochemical business in 2002 for \$2.5 billion and more recently GE's Plastics business in 2007 for \$11.6 billion. Middle Eastern countries had been viewed as willing to pay a premium for globally

<sup>2</sup> See *Government-Related Issuers: May 2007 Update*, Moody's document # 102945.

competitive assets and strong market positions. However, unlike the deals completed earlier this decade, they are no longer willing to pay a premium for these businesses.

Last December, Petrochemical Industries Company (PIC), a subsidiary of Kuwait Petroleum Corporation, refused to go ahead with an agreement to purchase 50% of Dow's commodity petrochemical businesses for \$7.5 billion. Many equity analysts had viewed this price as a significant premium to the value of these assets given current market conditions. The acquisition of NOVA for roughly \$2.2 billion is roughly half of the estimated replacement cost of these assets. We believe that this is a relatively cheap price to pay for these assets.

We believe that other Middle Eastern buyers will seek to greatly increase their global market share in petrochemicals during the current downturn. This may involve buying select assets from companies in bankruptcy, like LyondellBasell, or taking a large equity stake in distressed companies like leos Group Limited (Caa2, negative outlook). We also believe that Dow will find a partner for its commodity petrochemical businesses; however, the value of, and timing for, such a transaction is uncertain.

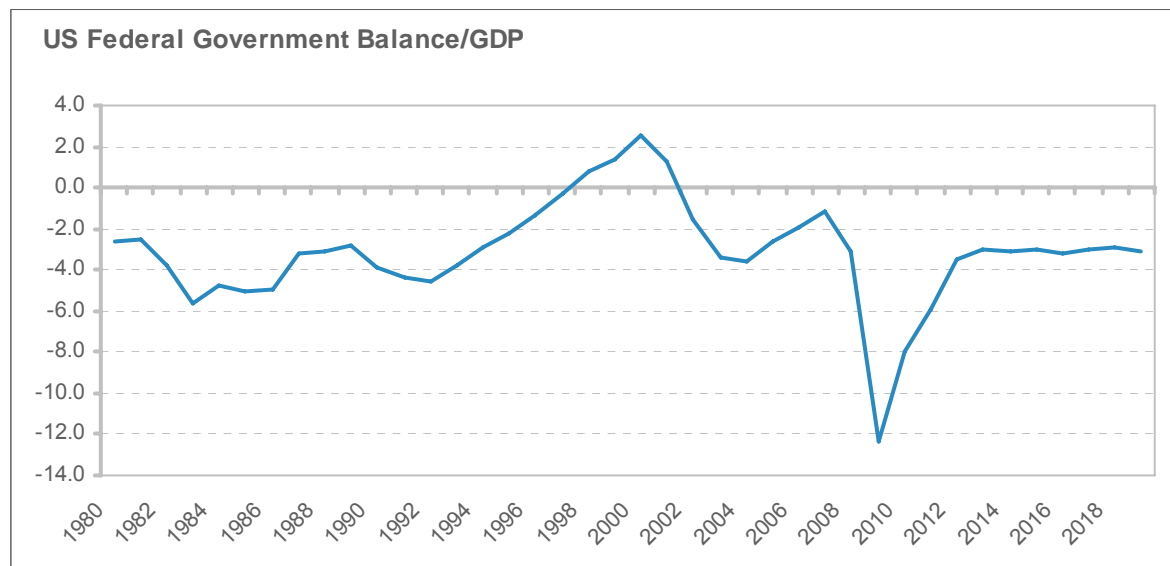
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## Sovereigns

### U.S. Budget: Strategy for Fiscal Adjustment, But Risks

The U.S. government budget for FY2010, which begins October 1, was released Friday. It shows a possible strategy for reducing the deficit and keeping the trajectory of federal government debt from rising unsustainably during the next decade. Importantly, it begins to assess the plausibility of future fiscal adjustment following the current crisis. However, it appears too optimistic in some of its assumptions.

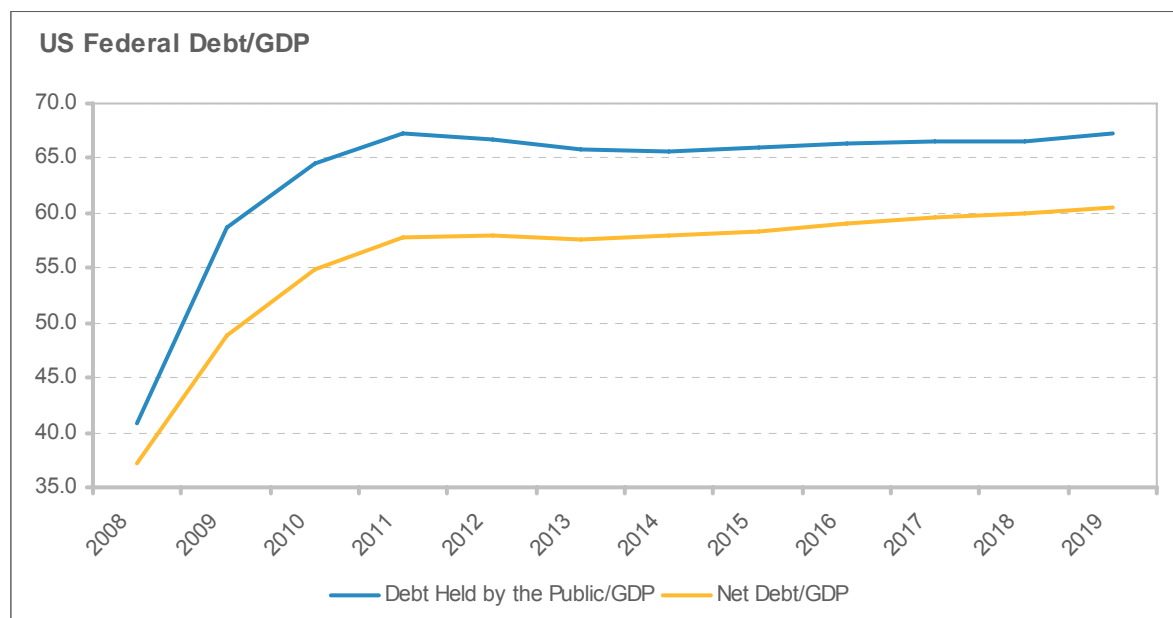
One factor in our Aaa rating of the U.S. government is its ability to make fiscal adjustments after the current credit crisis/recession abates. The government balance sheet is weakening considerably as a result of assistance to the financial industry, the effects of the recession on revenues and expenditures, and the economic stimulus package recently put in place. The budget is the first indication of how the new administration intends to restore a more sustainable fiscal position over the medium term. We see risks to the government's strategy, but it is useful as a first indication of how it intends to deal with the situation.



After the extraordinarily large budget deficit of 12.3% of GDP estimated for the current fiscal year, the budget projects a reduction to 8.0% in FY2010. This year's deficit is made larger by the inclusion of several one-time measures, including the Troubled Asset Relief Program (TARP), the first part of the tax reductions and expenditures under the stimulus package, and capital injections into Fannie Mae and Freddie Mac. The figures also include a contingency amount of \$250 billion for "additional financial stabilization efforts." The last item indicates, among other things, further capital injections into the banking system beyond amounts remaining in the TARP.

The FY2010 deficit figure also includes significant effects of the stimulus measures. After that, however, the budget projections show the deficit falling to 3.0% by FY2013 and remaining at about that level for the years through 2019. The most important items bringing about the drop in the deficit, aside from a revival of relatively strong economic growth, are higher taxes coming from the expiration of earlier tax cuts and a decline in defense spending. The expiration of the tax cuts may provoke political controversy.

The debt path resulting from these trends shows the ratio of debt held by the public to GDP peaking at 67.3% in FY2011 (vs. 40.8% at end FY2008) and remaining only slightly below that level through 2019. However, in a significant accounting move, the budget document also includes a net debt figure, since the TARP and other programs result in the government acquiring financial assets. Forecasts of the valuation of such assets are problematic. Nonetheless, the government's figures show net debt rising to about 60% of GDP by 2017. Evaluating debt net of financial assets is one aspect of our analysis of the government's creditworthiness.

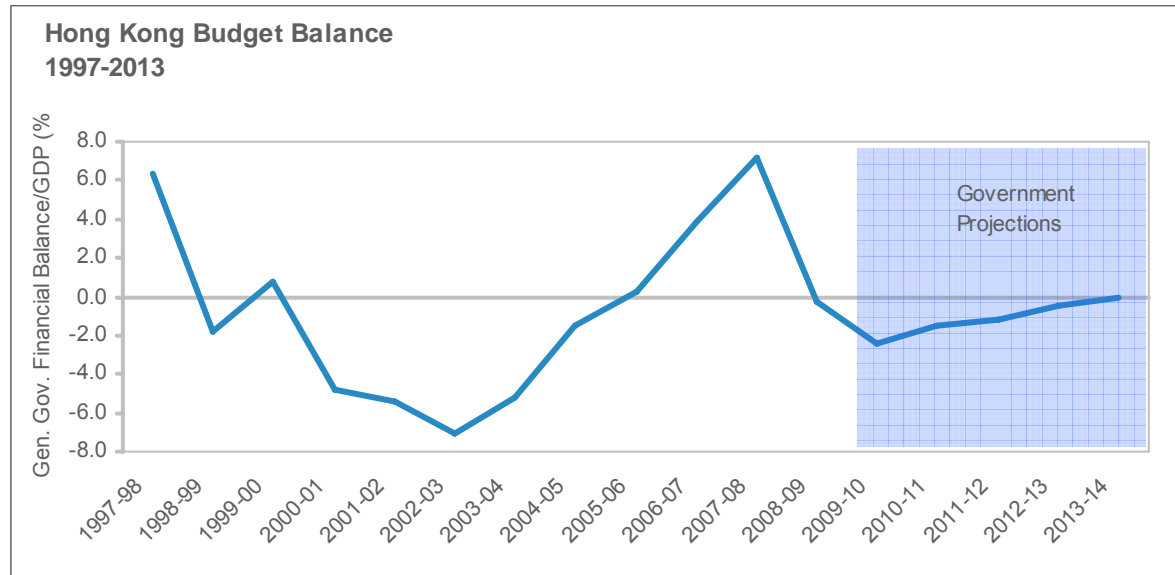


The U.S. budget process is less straightforward than that of many other countries. The initial proposal may be altered considerably. There are also substantial risks to the forecast, including in the rate of economic growth following the current recession and the cost of financial industry stabilization measures.

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## Hong Kong's Budget: Deficits, But No Rating Threat

Only a year after recording a record budget surplus of 7% of GDP in fiscal year (FY) 2007-08, Hong Kong's Financial Secretary presented a budget February 25 for the coming 2009-10 fiscal year that projects a deficit of 2.4% GDP and gradually declining deficits through FY2013-14. The forecast of a string of deficits does not change the stable outlook for our Aa2 government bond rating, however, because the government has almost no debt and very large fiscal reserves.



The move to deficit in the coming fiscal year results from the effects of the global recession on Hong Kong's economy and, therefore, government revenues, plus the stimulus package announced as part of the budget. The package itself was rather mild compared to stimulus measures implemented in other countries, with operating expenditure actually forecast to decline from the current FY's level. The mild stimulus package reflects the probability that fiscal policy alone may not be effective in counteracting the global forces buffeting the economy.

Without debt issuance, fiscal reserves are forecast to fall during the coming five years. Still, the reserves at the end of the period are likely to be equivalent to more than one year of government expenditure. Thus, in comparison to most other governments, Hong Kong remains financially strong, despite the effects of the current crisis. The government also announced a debt issuance program, although the proceeds will be kept in a separate account from the rest of the fiscal reserves. Nonetheless, on a net basis, the issuance of debt, which would mean less of a decline in financial assets, does not affect the net worth of the government.

Because of the very strong starting position of government finances, the deterioration in government debt metrics over the coming few years is unlikely to have an effect on our Hong Kong ratings. The government has recorded even larger deficits in the past without the need of debt financing. Our outlook for the ratings remains stable.

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## Export Carnage in the East Asian Big Three

The decline in exports from the largest countries in East Asia late last year continued into January. All three countries have also seen sharp declines in industrial output, as shown in the exhibit below. While the results are stunning, they present different challenges to each and alone do not necessarily weaken the credit fundamentals of the three countries.

	Nov-08	Dec-08	Jan-09
<b>Japan</b>			
Total exports (%change, yen, YOY)	-26.7	-35.0	-45.7
Industrial output index (%change YOY)	-16.6	-20.6	-20.8
<b>Korea</b>			
Total exports (%change, dollar, YOY)	-19.0	-17.4	-32.8
Industrial output index (%change YOY)	-12.7	-20.9	na
<b>China</b>			
Total exports (%change, dollar, YOY)	-2.2	-2.8	-17.5
Industrial output index (%change YOY)	5.4	5.7	na

China is now encountering the collapse in its double-digit growth rates. Real GDP will likely decelerate sharply from 13% in 2007 to around 6% in 2009 despite a massive policy effort to stimulate growth. Korea's GDP may contract around 3% in 2009 with downside risks threatening a repeat of the minus 6.7% collapse in 1998, the year after the outbreak of the Asia financial crisis. Japan's GDP might contract 4-5% in 2009, which would be the worst annual performance since WWII.

The immediate effect is on industrial output and growth in these countries. All three countries have stable rating outlooks. Nonetheless, this development means greater vigilance over whether Korea can continue to successfully manage the dollar funding squeeze on its banking system, thus ensuring the stability of its financial system and its balance of payments. A very sharp fall in exports could threaten the current account surplus we forecast for 2009, placing additional pressure on the ability of the Bank of Korea (BOK) to preserve a high level of official foreign exchange reserves. For Japan, the sharp fall in exports and growth means larger fiscal deficits. This will derail the governments' target to achieve a primary fiscal balance in FY2011. It may also dissipate upward momentum in our Aa3 rating of the Japanese government bond (JGB), which is at its current level following two upgrades since 2007. The immediate challenge for China is neither financial nor fiscal, but political. The government is seeking to maintain social stability in the face of rising layoffs and factory closures. We think the government can manage a temporary reduction in growth, as its external accounts will remain very strong (imports are falling faster than exports) and it has ample budgetary headroom for a large fiscal stimulus.

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## Korea Reduces Short-Term External Debt and Dollar Liquidity Threat

The government announced the first large drop in short-term external debt since it began building up in 2005. That, coupled with stabilization in official foreign exchange holdings, eases pressure on Korea's financial system and on the country's external payments position from the global dollar funding crunch.

The global credit crunch lowered such liabilities just about \$40 billion to \$151 billion in the fourth quarter of 2008. Taking into account maturing long-term debt, residual maturity short-term debt fell to \$194 billion in December 2008 from \$233 billion in September 2008. Official foreign exchange reserves have stabilized at slightly above \$200 billion in December and January, meaning that the External Vulnerability Indicator (the ratio of total external debt maturing in one year to official foreign exchange reserves) is 97%, a level that suggests reasonable protection against the continued dollar credit squeeze in the international financial market.

The utilization of roughly half of the \$30 billion temporary swap facility with the U.S. Federal Reserve Bank has helped ease pressure on Bank of Korea foreign reserve holdings. The facility was recently extended six months to October. But threats to the foreign exchange position of Korea could come from another spasm of deleveraging of equity portfolio holdings by foreign investors. There were more than \$30 billion in such outflows in 2008, but in the past two months there has been a modest net inflow. Another threat could come from the collapse in exports—if it leads to a large current account deficit. Currently, we are expecting neutral to mildly favorable developments on both of these fronts.

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## India Tested by Slowing Growth, Deleveraging, and Fiscal Slippage

Similar to the rest of the world, India's economic growth is slowing sharply with the intensification of the global economic crisis. GDP growth in the quarter ended December 2008 was 5.3% year on year. As a result, annual GDP growth in FY09 (which runs from April '08 to March '09) will be around 6.2%, considerably less than the rate achieved at the peak of the business cycle two years ago; and much lower than the 9-10% target envisioned in the latest 5-year plan.

Although risks to economic growth and budget performance are captured in the government's Ba2 local currency rating, downward pressure on the government's Baa3 foreign currency rating could arise quickly should the reversal of capital inflows from de-leveraging by foreign investors intensify.

Although India is a relatively "less open" economy with total trade amounting to under 50% of its GDP, which is lower than rest of East Asia, investment openness has increased substantially. Gross flows on the capital account grew rapidly to 65% of GDP at the end of FY2008 last March, up from just 17% in FY2003. Subsequently, large portfolio outflows have resulted in an erosion of foreign currency reserves, weakening the rupee. In addition, by tightening domestic liquidity and pushing up money market rates, global de-leveraging could continue to constrict investment financing and slow the economy even further.

The sharp deterioration in the fiscal deficit this year to nearly 11% of GDP, from 5.5% in FY08, has added to market pressures by creating a large supply of government bonds at a time when market liquidity has already been tight with interest rates rising. Of particular concern is that the government's populist social spending measures lack substantial economic multiplier effects. Farm debt waivers and rural employment guarantees, which amounted to nearly 2% of GDP in FY2008, have not prevented a 2.2% year-on-year contraction in agriculture sector output. In turn, this has contributed to the sharper-than-expected slowdown in the October-December 2008 GDP growth rate.

At a time of continued global economic stress, the government lacks a credible plan to restore fiscal rectitude and stem the erosion in modest gains made in fiscal consolidation achieved in the last few years. With national elections due in May 2009, we do not expect much clarity on medium-term fiscal policies until a new government takes office in June-July 2009.

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## Global Public Finance

### California Passes Budget, Ending Cash Crisis for Now

California has adopted a state budget. After months of impending cash crisis and political paralysis, the governor on February 20 signed a budget for fiscal 2009-10 into law. Noteworthy for what it achieved—major spending cuts and new revenues—as well as for what it did not achieve—a heavy reliance on one-time revenues pushes the state further into structural imbalance—California's new budget ends the immediate liquidity crisis the state was facing. The question is now whether the state's liquidity has permanently improved.

The passage of the budget has eased the most immediate concern, that of running out of cash in the near term and resorting to payment delays in order to preserve cash for priority payments. But it is not yet clear what effect the budget will have on the liquidity situation in the months ahead. The analysis of the liquidity situation, as well as the analysis of the state's long-term fiscal position as a result of the budget solutions, will be key to our resolution of the state's negative Watchlist status.

The budget closes a projected \$42 billion gap over the current and next fiscal year (fiscal years 2009 and 2010) with \$14.9 billion in spending cuts, \$12.5 billion in new taxes and fees, \$7.9 billion in federal stimulus funds to be used for gap-closing purposes, and \$5.4 billion in deficit borrowing. In addition, the governor vetoed almost \$1 billion in spending that was passed by the legislature. Highlights of the solutions are:

<b>Spending Cuts</b>	
Education	\$8.4 billion
Health and human services	\$1.6 billion
State employee furloughs	\$1.4 billion
<b>New Taxes and Fees</b>	
Sales tax (1-cent increase)	\$6.0 billion
Vehicle license fee increase	\$2.0 billion
Personal income tax (0.25% surcharge)	\$3.7 billion
Reduce dependent tax credit	\$1.4 billion
<b>Borrowing</b>	
Lottery securitization	\$5 billion

**Voter Approval Needed.** While the passage of the budget is a significant step, it is only the first step along the road to recovery. The budget contains items that must pass voter approval. The elections, to be held on May 19, 2009, will contain certain propositions that must pass for the budget to be balanced in its current state. Some of the propositions that will be on the ballot include:

**Proposition 1A:** Implements a spending cap based on the rate of growth from the last 10 years. Any tax revenues over that amount would be saved in a rainy day fund, which would be capped at 12.5% of revenue. Any amount above that could be used to pay debt or for one-time purposes. If voters approve Proposition 1A, the approximately \$14 billion of temporary taxes that are part of the budget deal will be extended for an additional two years.

**Proposition 1B:** Changes the state's education funding law to allow the state to cut education funding.

- Proposition 1C:** Borrows from future lottery earnings.
- Proposition 1D & 1E:** Take money from various funds to help balance the budget.
- Proposition 1F:** Prevents state-level elected officials from receiving pay raises in years when the state is running a deficit.

**Benefits May Only be Short-Term.** The majority of the new revenues in the budget are only short-term revenues, and thus are non-recurring. Most of them are in effect for two years, although, if the budget stabilization account reform passes, the sales tax increase gets extended by a year, the personal income tax surtax gets extended by two years, and the vehicle license fee gets extended by three years.

If the state's economic downturn continues for longer than expected, the short-term nature of the new revenues could result in the state facing crisis—again—in a few short years.

**Rating Implications.** The State of California is currently rated A1 on Watchlist for possible downgrade. When the Watchlist action was applied on January 21, we noted that as we assessed the credit, we would be keenly focused on liquidity. The passage of the budget has eased the most pressing concern, that of running out of cash and resorting to payment delays in order to preserve cash for priority payments such as debt service. We also noted, however, that when a budget was passed, we would assess how the budgetary solutions affect the state's expected cash flow through the end of the year. The state has not yet completed its revised monthly projected cash flow based on the budget, and thus we have not concluded yet whether the liquidity situation in months going forward has improved to a level sufficient to avoid any payment delays. Finally, we noted that we would assess solutions to determine whether they improve the long-term fiscal stability of the state, or whether they weaken it through reliance on one-time revenues, assumption of federal aid, or questionable deficit borrowings.

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## English Social Housing Facing Unprecedented Challenges

The global finance crisis and the worst UK recession in decades, has slowed government plans to meet ambitious housing targets and may put vulnerable housing associations (HA) in need of rescue or merger. Whilst the vast majority of the 2,000 associations, which provide low-cost housing to roughly two million households in the UK, can hunker down and stick to their low-risk rental businesses, many had been counting on housing sales to maintain surpluses for new investment and, in some cases, just to meet their operating margins. As in other countries, housing sales have dropped sharply and may have further to fall due to the scarcity of mortgages and doubts that prices have reached bottom.

Credit rationing from traditional lenders, the major UK banks have squeezed the working capital out of regional social landlords (RSL). There have also been reports that they have threatened to push up the cost of debt even for existing loans. Despite these problems, we anticipate that the UK government's long arm of funding (GBP8.4 billion from 2008-2011 authorized for RSLs and others for government supported housing), its close watch on the sector, and its influence as a growing shareholder in the UK banking system will maintain stability in the housing association sector. Mergers-as-rescues for smaller, weaker entities are likely to increase. During what may be a long and difficult downturn, we expect the regulator and main broker in arranging such rescues, the Tenant Services Authority, to be busier than usual.

The not-for-profit RSLs registered or housing association sector in the UK (of which England is, by far, the largest part in terms of population and economy) provides approximately half of the country's four million social-housing units. It is a core part of the social safety net and considered by those in and around government as a ready-made platform for stimulus investment within government's long-term housing plans of 3,000,000 new homes by 2016. We rate five flagship RSLs, all within the Aa2-Aa3 range, and provide credit estimates for scores more as part of structured borrowings. Key to the published ratings is the assumption of high probability of intervention by the UK government in the event of distress.

Moody's expects that the tight web of government funding and regulation of the sector will keep the bog-standard RSL safe. Direct government grants and rents, of which half come indirectly from the government, will continue to provide highly stable revenue. Tenants without support can apply for housing benefit, were they to lose their income; and such amounts can cover rental arrears. The regulator and the government agency for funding the sector, the Homes and Communities Agency, tend to intervene well in advance of difficulties nearing default. In the rare case of an RSL being pushed to the brink, the government has shown that it can intervene directly, and in the past provided a guarantee for an RSL near default.

In the meanwhile, the sector is likely to draw press interest due to its sensitive and essential social mission and due, like other subsidized not-for-profit sectors, to any factors (like the loss of sales), which will stand out against traditionally thin margins afforded by low government-set rents. For the most part, the "crisis" has centered on the loss of access to the sector's financing capacity for new builds, rather than a gathering risk to investors. Up against headlines regarding the banking system and government finances, restarting construction for social housing may have to wait its turn on what is likely a lengthy "to do" list for ministers. But, as seen by the occasional volleys between RSLs, the banks, and those in and near government, the sector will get attention and action when needed. Behind the headlines, the RSL sector will remain, at worst, an essential, if quiet, priority in the UK.

## Securitization

### Effect of MBIA Downgrade Muted on ABCP Programs

The February 18 downgrade of the non-municipal financial guarantee business of MBIA, now known as MBIA Corp., to B3 from Baa1, is not expected to affect the Prime-1 ratings of asset backed commercial paper (ABCP) conduits, even those with MBIA exposure. Prior to the most recent downgrade of MBIA Corp., most conduit sponsors had restructured their ABCP programs to reduce their financial guarantor exposure.

Historically, ABCP conduits have had exposure to financial guarantors from either: (1) the ABCP being fully or partially guaranteed by one or more financial guarantors; and (2) some of the assets of the ABCP program being guaranteed by one or more financial guarantors.

In general, the credit quality of the assets and any credit support for a Prime-1 rated ABCP program must be at least A2 or higher. At the present time, only two financial guarantors are rated at this level: Assured Guaranty Corp. (Aa2) and Financial Security Assurance, Inc (FSA) (Aa3).

ABCP sponsors have replaced credit support from financial guarantors that are now rated lower than A2 with letters of credit or loan facilities from banks that are rated A2 or higher or have deposited cash reserves. Assets that were insured by weaker guarantors are now either fully supported by either bank liquidity or by program credit enhancement from an entity rated at least A2. In other cases, the asset is rated high enough based on its underlying rating without relying on the financial guarantee. Finally, there are instances in which the bank sponsor of an affected conduit simply removed any assets that were rated below A2.

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### Auto Maker Restructuring Plans Affect ABS Differently

Despite the filing by Chrysler and GM of restructuring plans to the U.S. Treasury on February 17, we continue to believe that there is about a 70% probability that one or more of the Detroit Big 3 will file for a Chapter 11 bankruptcy with government DIP financing, a 25% probability of a government bailout without a near-term bankruptcy, and a 5% probability of a Chapter 7 "free fall" bankruptcy without government involvement.

The resulting scenario will have a greater impact on securitizations that have a relatively high linkage to the manufacturer and the greatest exposure to vehicle values (i.e., auto dealer floorplan and retail auto lease ABS), as compared to securitizations that have a relatively low linkage to the manufacturer and the least exposure to recovery values (i.e. prime retail auto loan ABS).

Performance of dealer floorplan and retail auto lease ABS hinges on recoveries. Many new car buyers may be reluctant to purchase from a bankrupt manufacturer. For instance, depending on the strength of consumer reluctance, GM predicts 50% to 80% of its customer base could be eroded in a Chapter 11 bankruptcy lasting two years. We consider this consumer reluctance in our recovery stresses for auto dealer floorplan and retail auto lease ABS. For these assets, we apply different stress recovery assumptions in each of three different reorganization and liquidation scenarios. With prime retail auto loan ABS, the consumer must first default on his loan before recoveries have an impact on performance. Since the prime retail auto loans have a low frequency of default, recoveries typically have a lower impact on performance as compared to other vehicle-backed ABS. Performance of dealer floorplan ABS is also linked to the health of the dealer network. While increased dealer defaults will occur in a restructuring, we expect higher defaults in a liquidation scenario. Even if vehicle sales drop in a restructuring, the manufacturer will be focused on maintaining its franchise. A bankruptcy may give a manufacturer a greater ability to pare down its dealer base into a stronger, more solvent network since dealers often have protections under state franchise laws and in their dealership contracts. A drastic decrease in sales will lead some dealers to default, even if they are not cut in a restructuring. In addition, a Chapter 11 restructuring should have a neutral effect on the bankrupt manufacturer's servicing and collections. If the Chapter 11 converts into a Chapter 7 liquidation, we expect that servicing and collections may be negatively impacted resulting in higher losses.

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## **Impact of Proposed Elimination of the FFELP Student Loan Program**

The 2010 U.S. budget unveiled by the Obama administration last week includes a proposed shift of all student loan originations from the Federal Family Education Loan Program (FFELP) to the Direct Lending (DL) program by 2010. We expect the credit quality of existing FFELP ABS securitizations will not be materially impacted if the change were enacted. With respect to the fundamental ratings of large, publicly held lenders, on February 27 we placed all ratings of SLM under review for possible downgrade, but took no rating action with respect to Nelnet.

Under FFELP, private lenders, such as Sallie Mae and Nelnet, originate government guaranteed student loans that are typically financed in the securitization markets. The federal government extends the loans directly to the students under the DL program. In 2008, approximately \$90 billion of loans were estimated to be originated under the FFELP program compared to \$18 billion under the DL program.

This is not the first time that FFELP has been under siege as some lawmakers have historically strongly supported the alternative DL program. If legislation were enacted, we expect that smaller servicers may find it more economical to exit the business and transfer their servicing portfolio to another servicer. Providing the servicing transfers are orderly, the impact on FFELP ABS will be minimal, and FFELP servicing is very standardized and easily transferable.

The SLM rating action reflects uncertainty regarding SLM's business plan in view of the president's proposed budget and its prospective effect on FFELP. During the review period, we will seek to clarify how a termination of FFELP would affect the company's earnings capacity and business mix, including potential ramifications for the company's private credit business and operating cost reduction program.

During the review, we will also evaluate SLM's plans for generating sufficient liquidity to meet unsecured debt maturities as the company faces a significant maturity schedule over the next several years. We will also review the company's ability to manage the credit risk inherent in its \$36 billion portfolio of non-government guaranteed private education loans.

In the case of Nelnet, we took no rating action as the result of the announcement of the proposed budget. Nelnet has shifted its business model markedly toward fee-based businesses and is less affected by the proposed elimination of FFELP.

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## U.S. Accounting

### Five Key 10-K Disclosures for Fixed Income Investors

Today is the filing deadline for annual reports on Form 10-K for large, calendar year-end U.S. public companies. The 10-K is generally the single most valuable source of information that companies publish each year. The filings can easily cover several hundred pages and are crammed full of useful information to complement previous quarterly filings and earnings releases. But it's easy to get buried in all the detail....so here are five key disclosures that fixed income investors should consider thumbing to first.

**Defined Benefit Pension Plans.** Since pension plan assets and liabilities are only measured at year-end, this will be the first opportunity for investors to see the impact that the annus horribilis that was 2008 had on defined benefit plans. Plan investments have been battered. This has likely caused most plans to be in a deficit position. Look for disclosures in the financial statement footnotes that compare benefit obligations and plan assets to arrive at the funded status at the end of the year. Companies must also disclose how much cash they are required to contribute to their plans in 2009. Increased pension obligations are unlikely to be the sole driver of ratings downgrades for issuers with adequate liquidity, sufficient resources to alleviate their funding deficiency over time, and financial metric contraction is modest. Also, there will be tolerance for financial ratios to temporarily deviate from the range of expectations for the rating in some cases. However, increases in pension obligations will contribute to a number of downgrades. Growing deficits will stress leverage metrics and required payments to fund plans could add further strain to the liquidity of companies that are already struggling to adapt to changed economic conditions. We will soon publish a special comment that provides additional commentary on the rating impact of these matters.

**Securitization Structures and Other Off-Balance-Sheet Vehicles.** Last fall, the Financial Accounting Standards Board (FASB), at the direction of the U.S. Securities and Exchange Commission (SEC), issued two exposure drafts which, if adopted, will result in the consolidation of many securitized structures on company balance sheets. Final standards are expected this year and will likely be effective in the first quarter of 2010.

As an interim step, the FASB issued disclosure guidance in December that will be effective for 2008 10-Ks. The guidance requires public entities to provide additional disclosures about the transferor's continuing involvements with transferred financial assets, as well as requiring disclosures of sponsors or servicers of special purpose entities. These disclosures are intended to provide better transparency to investors regarding a transferor's ongoing exposures to risk related to transferred assets and a company's involvement with variable interest entities (VIEs). It should provide users with insights into what structures may be coming back on balance sheet in 2010 and what the financial statements will then look like.

**Originators of Credit Derivatives.** The FASB also issued guidance that improves disclosure requirements for sellers (but not purchasers) of credit derivatives and financial guarantees, beginning with 2008 10-Ks. These new disclosures significantly improve transparency and provide meaningful insight into the risks assumed by sellers of protection under credit derivatives. Sellers of credit derivatives are required to disclose:

- The nature of the credit derivative, including term, rationale for entering, events that would trigger performance, and current status;
- Maximum potential payments that could be required under the credit derivative;
- Fair value of the derivative;
- The nature of recourse provisions or collateral available to the seller to recoup payments paid under a derivative contract.

**Fair Value of Financial Instruments.** With market turmoil continuing, investors will want to analyze disclosures related to fair value measurements. Of particular interest could be transfers in or out of the "Level 3" (i.e., mark to model) category under statement of financial accounting standards (SFAS) No. 157, fair value measurements, and income recorded on Level 3 assets or liabilities. As market activity has been constrained, firms may shift assets to Level 3, which is based on unobservable inputs, from levels 1 or 2 that reflect observed market transaction prices. As Level 3 valuations are more subjective by nature, it would behoove users of financial statements to closely inspect gains or losses arising from them.

Another fair value-related item that is increasingly affecting financial institutions is other-than-temporary impairment (OTTI) charges on financial assets. There are no bright-line tests under the accounting rules that require investors to take OTTI charges if a debt security has been under water for a specified length of time. As the financial crisis continues, firms will face increasing pressure regarding their OTTI judgments. Of particular interest to investors will be the amount of unrecognized deferred losses in the accumulated other comprehensive income category of equity related to underwater available for sale securities and the supplemental disclosure of fair value of held to maturity securities. These disclosures will be helpful in understanding OTTI charges that could be taken in coming quarters.

**Audit Opinions.** The auditor's opinions on the financial statements and on compliance with Section 404 of the Sarbanes Oxley Act should always be amongst the first places to look in a 10-K.

In forming an opinion on the financial statements, auditors must consider the company's ability to continue as a going concern. This review is of heightened importance during the current adverse conditions that most companies are struggling through. In our experience, auditors are reluctant to issue an adverse going concern opinion unless the company has reached a point of no return. We expect more companies to fall into this trap in the current cycle of 10-Ks compared to recent years and we expect to see a dramatic increase in the number of audit opinions with going concern language as a result.

It seems like a long time has passed since compliance with the Sarbanes Oxley Act and other regulatory measures were major concerns of public companies. There are certainly many other pressing issues that are now facing companies, but it is essential not to lose track of the basic need for companies to maintain appropriate internal controls over both their assets and their financial reporting. Historically, we have taken rating action, in part because of control problems, in roughly 20 percent of the companies that reported internal control compliance issues. We have often noted that the most serious control problems reside in companies that are unable to file their financial statements by the SEC's deadlines. Accordingly, large companies that do not file their 10-K by today's deadline may warrant closer inspection.

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## Market Review & Outlook

By James Parascandola, Vice President, Moody's CreditQuotes

### High Grade Credit Looks Set to Outperform High Yield

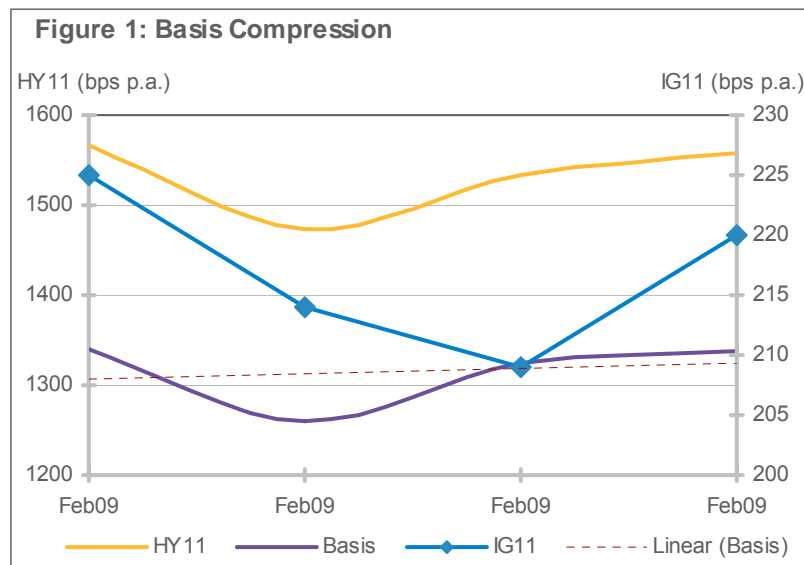
The outperformance of bank CDS spreads, beginning on midday Tuesday, put an end to two weeks of widening, and we believe has established a floor from which credit spreads can rally further. The recurring theme of the performance of bank equities and credit assets setting the tone for the broad markets is one that we've noted previously. We believe that it will remain the case in the future in terms of both spread direction and spread volatility.

Another familiar trend, discussed below, is that of the spread compression between the US investment grade CDS index (IG11) and its high grade counterpart (HY11). So far this year compressions have been short lived. We believe that their waning presents market participants with opportunities to capitalize upon our view that high yield spread product will continue to underperform its investment grade counterpart in the period leading up to the peak in corporate default rates, probably in the fall.

Overall, as stability returned to bank credit spreads so too did an increase in CDS trading, along with intraday spread volatility. But away from banks, any move by CDS spreads to rally was kept in check by the depressed performance of equities, as concerns about economic fundamentals and governmental policy direction weighed on investors' minds.

#### IG11/HY11 basis compression

Throughout the course of the year we have discussed the relative performance of the investment grade and high yield credit derivative indices; namely that investment grade credit should continue to outperform its high yield counterpart. We've also reviewed how technical factors can provide investment opportunities in this regard. In this connection we note that short term technical drivers of spread volatility (such as supply and demand imbalances or short covering) can be just as powerful, if not more powerful, than traditional drivers, namely fundamental credit factors.



As shown in Figure 1, last Tuesday's market rally resulted in the basis (i.e., the spread differential between IG11 and HY11) compressing by 82 bp as short covering in HY11 fueled its run higher relative to IG11.

As the rally lost steam and the markets resumed normal trading patterns, the basis snapped back 79 bp to its trend line of around 1,340 bp. One strategy to capitalize on this trend is to go long HY11 risk and short IG11 risk when

the basis deviates 5% or more from its trend line. Being so set up going into Tuesday's rally, and then reversing the positions, would have netted a 161 bp (12.2% return) while maintaining a nominally risk neutral trade profile. In sum, investors who share our view that high yield spreads will continue to underperform investment grade spreads can potentially capitalize on presumably temporary compressions of the basis, at least until later this year.

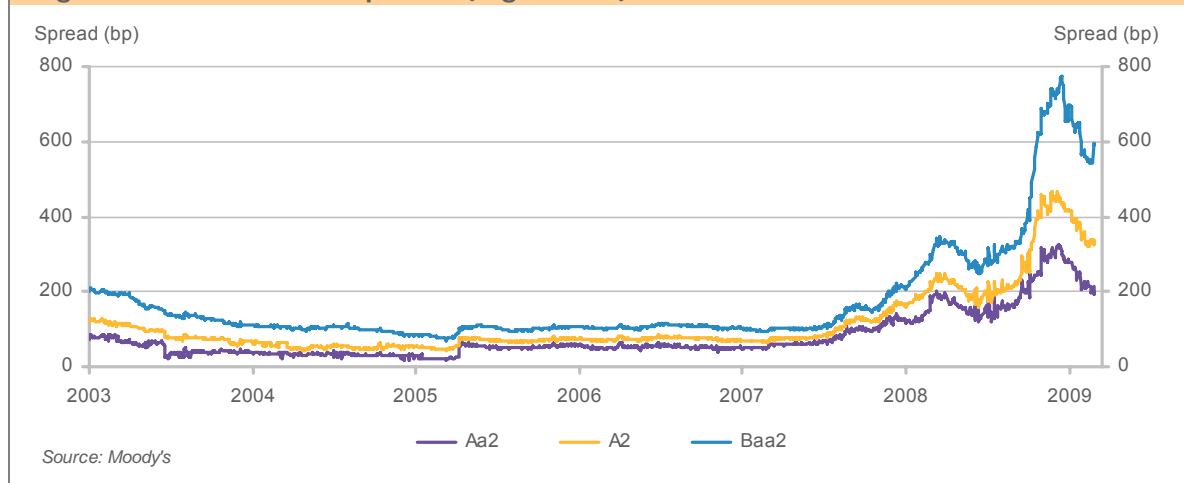
## Looking Ahead

With time comes clarity, or so the market hopes. As we saw this past week, the government's increased stake in Citibank brought with it a calming and tightening effect to spread product, mainly as a function of tighter bank spreads. As more data (from balance sheet stress tests) and plans (in the form of governmental interventions) become available, we expect this trend to gain momentum.

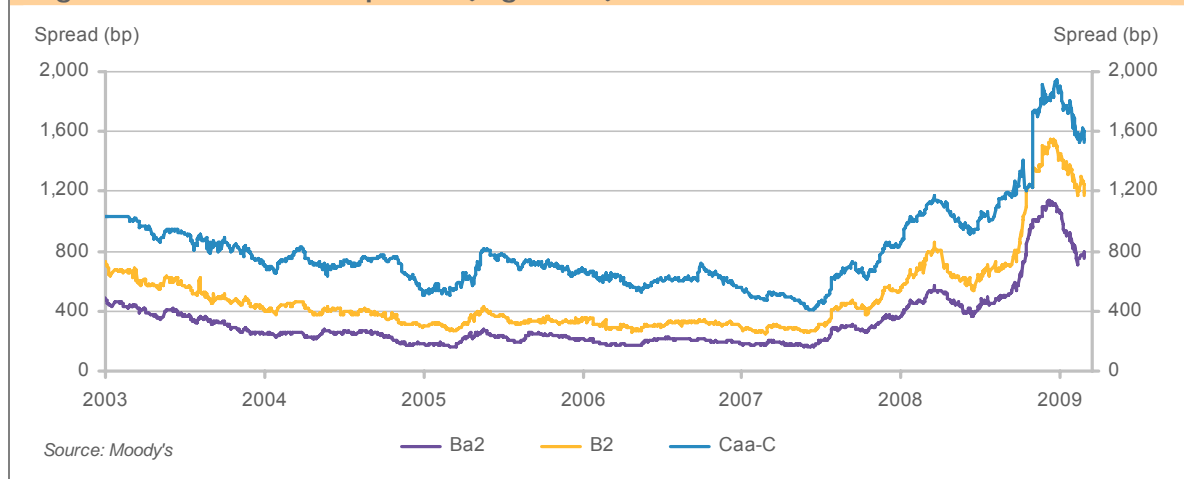
Even in the face of deteriorating equities, bank stocks and credit spreads demonstrated resilience this week, some more than others. We expect the upcoming week and months to demonstrate more of the same. One consequence is that we expect to begin to see a divergence among the leading US financial institutions, with the best in breed distinguishing themselves from their peers.

## Spreads

**Figure 1: 5 Year Median Spreads (High Grade)**

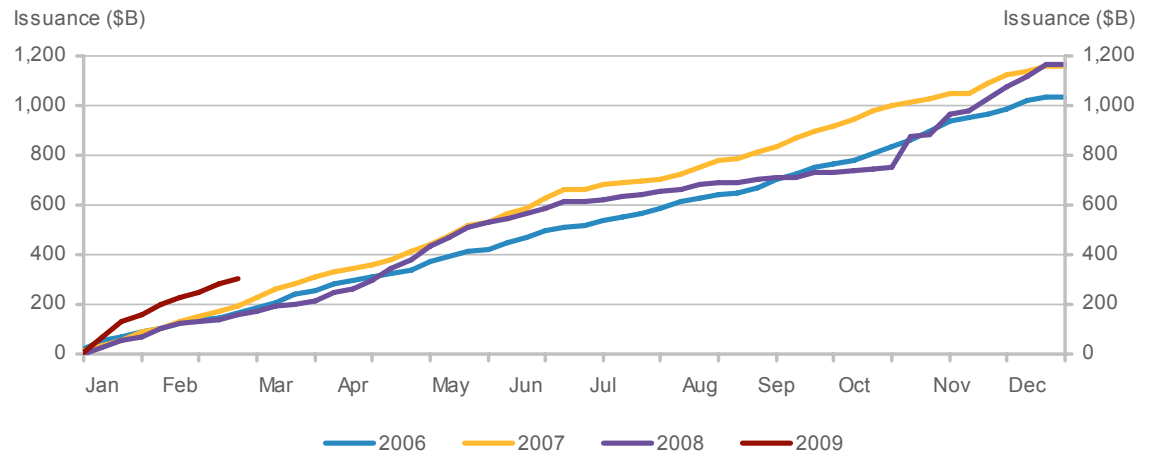


**Figure 2: 5 Year Median Spreads (High Yield)**



## Issuance

**Figure 3: Market Cumulative Issuance - Corporate & Financial Institutions: USD Denominated**



**Figure 4: Market Cumulative Issuance - Corporate & Financial Institutions: Euro Denominated**

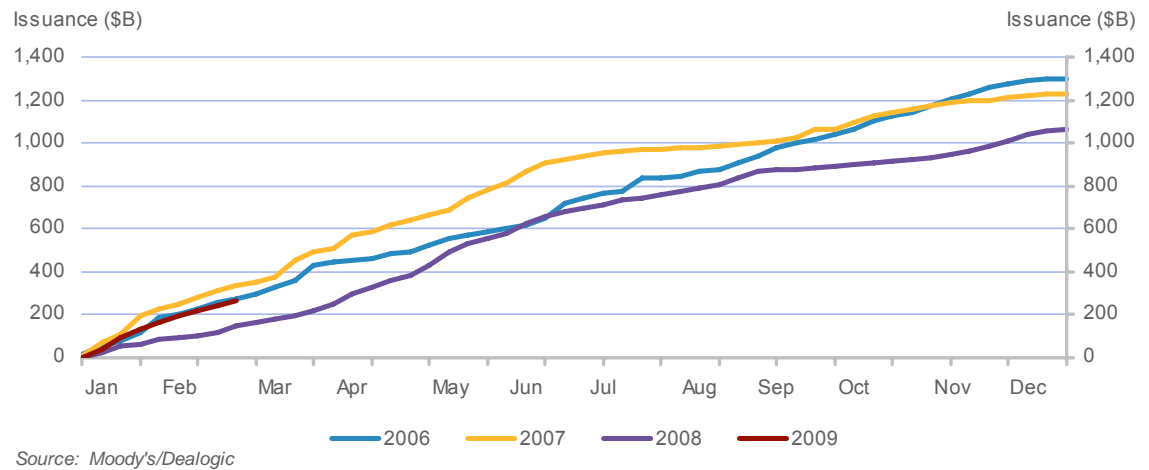


Figure 5: Issuance: Corporate &amp; Financial Institutions

		USD Denominated		
		Investment-Grade Amount	High-Yield Amount	Total* Amount
		\$B	\$B	\$B
Weekly		19.839	1.070	21.001
Year-to-Date		232.105	11.937	300.696
		Euro Denominated		
		Investment-Grade Amount	High-Yield Amount	Total Amount
		\$B	\$B	\$B
Weekly		23.105	0.000	23.375
Year-to-Date		257.733	0.368	265.728

*\*Difference represents issuance with pending ratings.*  
Source: Moody's/Dealogic

## The Macro View

*By John Lonski, Chief Economist, Moody's Capital Markets Research Group\*  
Ben Garber, Moody's Capital Markets Research Group\*  
Chris Snyder, Moody's Capital Markets Research Group\**

### Fiscal and Monetary Stimuli Should Help End Recession by Year's End

Just as economic growth sometimes can be unsustainably rapid, contractions of business activity also can be unsustainably severe. It is conceivable that Q4-08's 6.2% annualized quarterly contraction of real GDP may prove to be the worst of the current recession, not so much because of improving fundamentals, but rather because of how the desire to maintain living standards has reduced the scope of a further retrenchment of household expenditures.

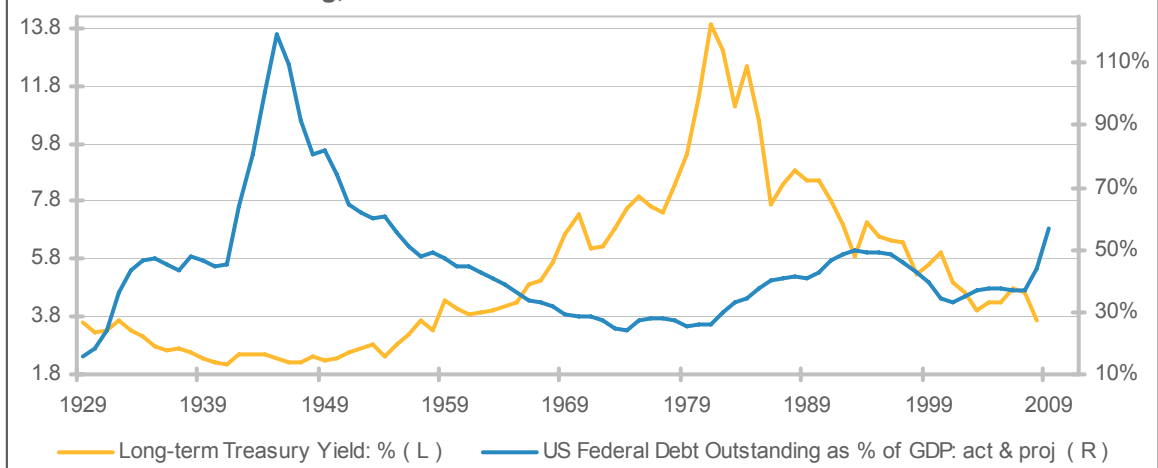
An easing of the severity of the current recession requires that the deterioration of consumer spending ebb considerably. January's 1.0% monthly increase by retail sales—the first monthly increase by retail sales since June 2008's 0.1%—favors a noteworthy moderation of real consumer spending's 4.3% annualized quarterly contraction of Q4-08. In turn, the annualized quarterly contraction of real GDP could narrow from Q4-08's -6.2% to -5.5% for Q1-09, despite the likelihood of a deeper contraction of residential investment spending, a wider trade deficit, and a more pronounced depletion of inventories. By Q2-09, the quarterly contraction of real GDP should ease to something resembling a 1.0% annualized retreat. Thereafter, real GDP should stabilize in Q3-09 and then grow sequentially by Q4-09.

Nonetheless, any forecast of a return to growth by year's end entails speculation. Whether or not monetary and fiscal stimuli will be employed effectively remains in doubt.

To quell the runaway price inflation of 1980-1981, then Fed Chairman Paul Volcker had the courage to do the unthinkable and hike fed funds above 19% in June 1981. Soon, Ben Bernanke might yet seize the moment and engineer a decline by mortgage yields, without which home sales will continue to sink. **An end to both the current recession and attendant financial market turmoil requires the return of recurring sequential growth for home sales.**

Thus far, the dollar exchange rate has held its ground despite the administration's unveiling of the biggest federal deficit relative to GDP since World War II. In the event that proposed fiscal and monetary stimuli scare off foreign investors, Washington will need to rethink its strategy.

**Figure 1: Treasury Bond Yields Do Not Always Move in the Direction Taken by Federal Debt Outstanding, as a % of GDP: 1929-2009**

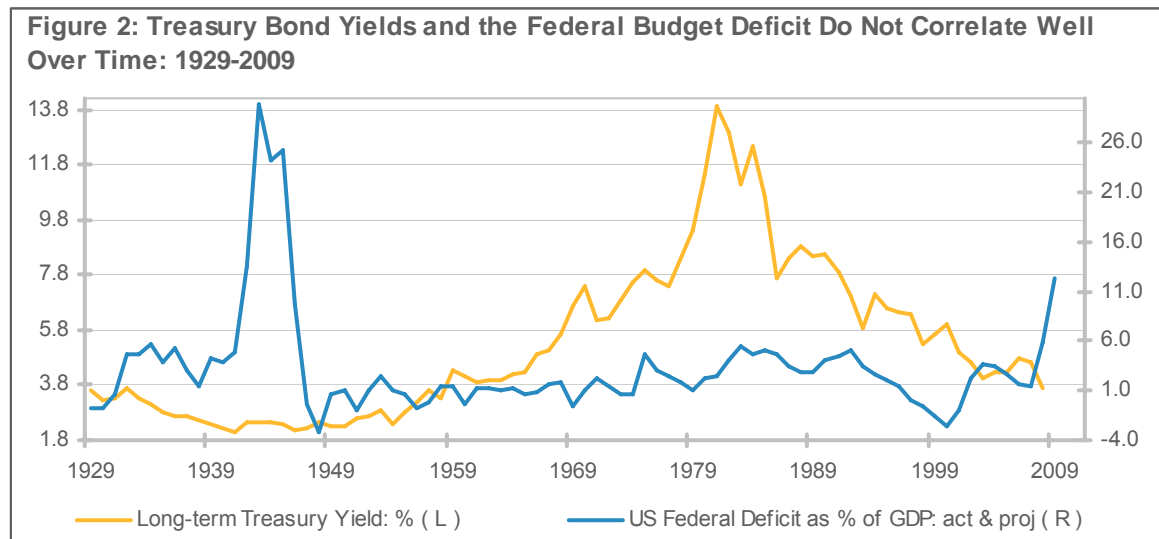


The Obama administration's proposed \$1.75 trillion federal budget deficit for fiscal 2009 approaches 12.4% of prospective GDP, which would be the steepest such ratio since the budget gap approached 25% of GDP in 1945. Moreover, 2009's prospective ratio of the federal budget deficit to GDP well exceeds 1934's 5.6% peak of the Great Depression.

The size of the projected deficit relative to GDP is so great that it may prompt upward revisions of future real GDP growth. Partly because of the stimulatory effect of a huge budget deficit, the administration's economists forecast 3.3% growth for 2010's real GDP, which is well above a recent consensus projection of 2.1%. But, for now, equity prices keep sinking to new lows despite a massive budget deficit's potential to spur the economy.

The US economy would grow at a breakneck pace not long after the budget gap rose from fiscal 1982's 3.4% to fiscal 1983's 5.7% of GDP. By contrast, the Obama administration's latest proposal has the deficit soaring from fiscal 2008's 3.2% to fiscal 2009's 12.4% of GDP. The budget gap's anticipated jump vis-à-vis GDP would be the steepest since 1942-1943. Real GDP expanded by 14.6% in 1942 and by another 16.0% in 1943.

However, the forthcoming deficit's lift to expenditures may be limited by how a significant portion of the budget gap will do little more than recapitalize weakened financial institutions. Still, ***the sheer magnitude of the projected deficit should help to end the recession by Q4-09.***



Although upward pressure will be put on benchmark Treasury yields, still very wide corporate bond yield spreads preserve the possibility of a decline by the absolute levels of corporate bond yields as credit risk premia narrow in response to the impending return of economic growth.

Many agree that a decline by medium-grade corporate bond yields is likely. A late February consensus forecast predicts that February 26's long-term Baa corporate bond yield of 8.21% will average 7.9% in Q2-09, 7.7% in Q3-09 and 7.6% in Q4-09. As derived from the consensus forecast of the long Treasury bond yield, the Baa corporate bond yield spread over its benchmark 30-year Treasury yield is implicitly expected to narrow from February 26's 454 bp to 390 bp, on average, for Q4-09. The latter appears to be well within reach.

A 390 bp Baa corporate bond yield spread for Q4-09 would well exceed its 169 bp average of the 15-years-ended 2007, including its 280 bp maximum of that span. Fourth-quarter 2009's prospective 390 bp average spread for the long-term Baa corporate bond index also tops November 1982's 376 bp high of the span covering 1934-2007.

Effective fiscal and monetary policies could prompt unexpectedly deep declines by private-sector borrowing costs. Not to be overlooked is how rapidly corporate bond yields fell and spreads narrowed as the US economy pulled away from the worst year of the Great Depression.

After peaking at the 10.67% of June 1932, the Baa corporate bond yield would then sink to the 6.62% of June 1933 as its spread over Treasuries narrowed from 691 to 341 bp, respectively. The Baa corporate bond yield spread was essentially halved from June 1932 to June 1933. A halving of December 2008's latest peak of 557 bp for the Baa corporate bond spread would lower this credit risk premia to a still historically wide 279 bp.

In view of how a significant moderation of monthly job losses does not yet impend, the near-term outlook for consumer spending is fraught with risk. Still, the recent severity of the decline in real consumer spending suggests that the scope for further reductions in household expenditures has been narrowed. From the first to the second half of 2008, real consumer spending shrank by 2.7% annualized which, since 1946, was second only to the 3.5% collapse of the span ended Q3-80 in terms of severity.

A deepening of its annualized quarterly contraction from Q3-08's 14.8% to Q4-08's 22.1% left real spending on consumer durables down by 11.4% from Q4-07. The latter was the deepest annual contraction since the 12.2% of Q2-80.

Since 1946, there are only 10 previous episodes where the annualized quarterly contraction of real spending on consumer durables was deeper than 20%. For the quarters immediately following the 10 earlier deep sequential contractions by purchases of consumer durables, real spending on durables achieved ample annualized quarterly advances of 21.8% in terms of its sample average and 13.7% in terms of a median. In only two of the 10 instances did real spending on durables decline in the following quarter, the deepest being the 8.0% annualized contraction of Q3-51.

Fourth-quarter 2008's real consumer spending also contained another extremely deep setback whose correction favors a comparatively better showing by Q1-09's consumer spending. Following Q3-08's already deep 7.1% annualized quarterly decline, real purchases of nondurable consumer goods contracted by a record 9.2% annualized in Q4-08. The previous record contraction for this statistic was Q4-50's 8.2% plunge that was immediately succeeded by the 10.5% surge of Q1-51.

The record-breaking annualized sequential contraction by real spending on consumer nondurable goods of Q4-08 owed much to an accompanying record-smashing 14.7% plunge by real spending on food. Unless Americans are dieting in a manner never seen before on so grand a scale, a sizeable quarterly increase in the real consumption of food impends.

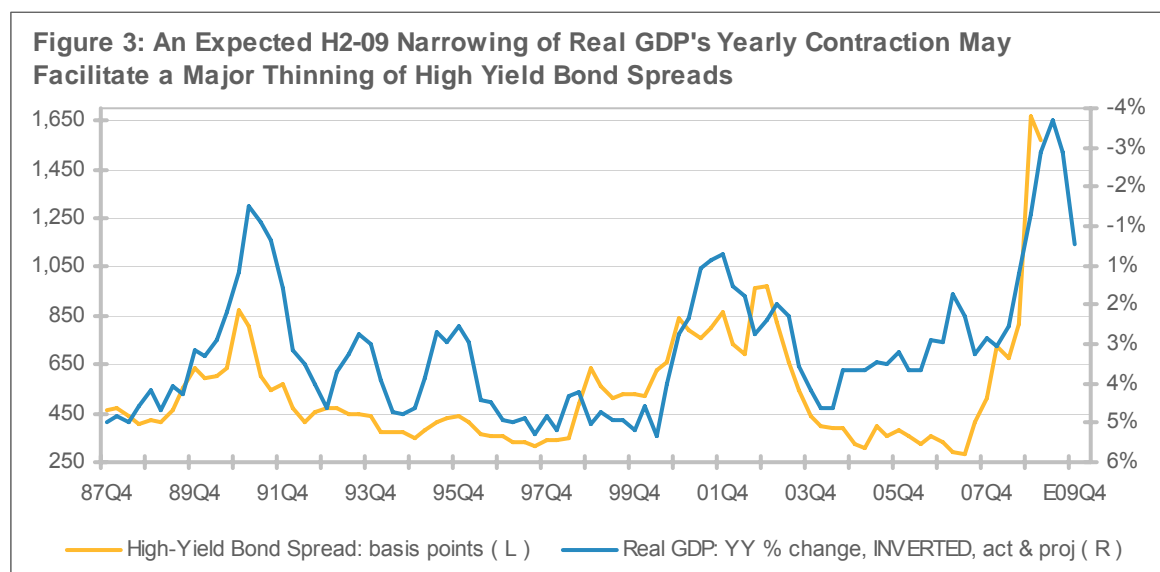
***Even if unemployment extends its climb into 2010, a stabilization of real consumer spending could be established by Q2-09. Although consumer spending may be the first major component of GDP to steady, its performance should remain well under its trend of the past 20 years.*** By Q2-09, the year-to-year contraction of real consumer spending should bottom at something close to Q3-51's post-1946 record low of 2.3%.

Any stabilization of the US economy, including the financial system, probably is contingent on a bottoming of housing. January's results on unit sales of new and existing homes were hardly encouraging. Worse yet, the latest contraction of mortgage applications from potential homebuyers seems to be intensifying. Granted that a broadening of tax credits to certain homebuyers should help, ***a resolution to housing's crisis probably requires substantially lower mortgage yields.*** The Federal Reserve will face up to this imperative and do whatever is necessary to substantially lower mortgage yields fairly soon.

Business capital spending should be the last component of GDP to stabilize. The now deep contraction of new orders for nondefense capital goods warns of a continued shrinkage for real business investment in equipment and software, which plunged by 28.8% annualized from Q3-08 to Q4-08. The accompanying shallower 5.9% annualized decline of real business spending on business structures will deepen according to a record low architectural billings index and the exceptionally restrictive lending conditions now confronting the commercial real estate industry.

Fourth-quarter 2008's 5.0% year-to-year decline by real business investment spending should ultimately bottom with a contraction of 12% by Q3-09. Growth may not return to real business investment on a year-to-year basis until Q2-10. The annual contraction of real investment in business structures is expected to bottom with the prospective 23% plunge of Q4-09. Yearly growth may not return to this important component of commercial real estate construction until the final three months of 2010. Although the yearly contraction of real business investment in equipment and software may trough in Q2-09 with a drop of nearly 13%, the category may not grow on a year-to-year basis until the first quarter of 2010.

The record shows that conditions in the financial markets, particularly the credit market, tend to materially improve after the annual contraction of real GDP bottoms. Our current view is that the annual decline of real GDP will bottom in Q2-09 at 3.2%, which would be the deepest such decline on record for a sample that starts in Q1-48. The unexpected severity of real GDP's unfolding contraction helps to explain why corporate bond yield spreads earlier widened to bands not seen since the 1930s. If the economy had been fundamentally sound, the mid-September collapse of Lehman would have been far less disruptive to both the financial markets and the economy.



## U.S. Financial Outlook

*By John Lonski, Ben Garber, and Chris Snyder, Moody's Capital Markets Research Group\**

### Credit Spreads

As measured by Moody's long-term average corporate bond yield, the recent investment grade corporate bond yield spread of 303 basis points, which is wider than November 1982's post-1930's high of 254 points, seems to have priced in a likely further deterioration of corporate credit worth. A stimulatory monetary policy, the biggest fiscal stimulus package vis-à-vis GDP since World War II, and extraordinary efforts to assure an adequate supply of financial capital should moderate the US' recession by Q3-09 and, thereby, ease the deterioration of debt repayment. Also, Washington probably will strive to lessen systemic risks by doing whatever is necessary to prevent the collapse of a major investment-grade borrower should the need arise.

The recent high-yield bond spread of 1,605 basis points appears to offer adequate compensation for an expected climb by the US' high bond default rate to a new record high of 16.4% by November 2009. The combination of a very severe recession and extremely limited access to financial capital will prevent the composite high-yield bond spread from narrowing much from its latest width. Although the high-yield spread may not return to its 2,025 basis points high of December 16, 2008, occasional broadenings of this spread are possible until a credit cycle bottom comes into view. A year from now, the high yield bond spread is likely to be several hundred basis points thinner and, thus, much closer to October 2002's previous post World War II high of 1,100 basis points, as opposed to its 440-point median of 1985-2007.

### Defaults

Moody's forecasts that the US' trailing 12-month high-yield default rate will rise from January 2009's 5.2% to an expected peak of 16.4% for November 2009. Thereafter, the default rate is projected to dip to December's 15.8% and to 15.6% by January 2010. In general, lower-than-expected sales will expose the vulnerabilities of weaker credits, while much diminished access to financial capital will impede refinancings, reduce amounts that can be raised via asset sales, and make it more difficult to fund cash shortfalls.

### U.S. Corporate Bond Issuance

After sinking by 14% annually in 2008, US corporate bond issuance probably will grow by 7% in 2009. Investment-grade corporate bond issuance should recover from 2008's 6% decline with a slight 7% gain for 2009. Both the FDIC's guarantee of new financial institution offerings (having a maturity of less-than-three years) and reasonably attractive borrowing costs for solid investment-grade credits will lend support to high-grade issuance. The annual contraction of high-yield bond issuance is expected to narrow from 2008's 60% plunge to a 30% setback for 2009, with the bulk of lower-grade offerings occurring during the final four months of 2009.

### U.S. Economic Outlook

The consensus forecasts a moderation of the quarterly contractions of real GDP after Q1-09 and projects that by Q2-09 the yearly contraction of real GDP should bottom, while the annual increase of the unemployment rate peaks during the summer. The biggest fiscal stimulus package relative to GDP since the Second World War will help facilitate a second-half 2009 stabilization of economic activity. By Q4-09, the economic environment should be much less of a drag on credit worth. To the degree that macroeconomic risks fade, financial institutions may be more willing to assume credit risk.

## European Financial Outlook

*By Christine Li and Kimberly Forkes and the European staff of Moody's Economy.com*

### Credit Spreads

***Over the coming months we expect European investment grade spreads to widen by at least 50 bp from their current level of 300 bp. A further contraction of economic activity, and very tight credit conditions are likely to weaken corporate earnings and balance sheets, causing spreads to widen further.***

The January to mid-February rebound in spreads has proven to be temporary. Investment grade corporate fundamentals are expected to deteriorate as the recession in Europe worsens. Spreads are likely to remain above pre-credit crunch levels at least until the second half of this year. On a slightly positive note, we believe that corporate bond markets will start to recover and spreads narrow before economic activity picks up in 2010.

The drivers of tight investment grade credit market conditions include bank deleveraging and the sale of bad assets, curbed lending to the private sector, and squeezed corporate profit margins due to tight credit conditions and high borrowing costs.

***Over the coming months we expect European speculative grade spreads to widen by at least 150 bp from their current level of 1685 bp, as credit fundamentals deteriorate and default rates start to rise sharply.***

The recent narrowing of euro denominated high yield spreads has proven to be short lived. The deterioration in credit quality has only started to accelerate. Currently, European default rates are at a low level, but we expect them to pick up sharply. During the last credit downturn, high yield spreads rose rapidly prior to the surge in corporate defaults. Spreads only began receding after defaults peaked. Since actual corporate defaults are only rising slowly, high-yield spreads could well widen further in the near term.

### Defaults

***We expect the European 12-month default rate to rise to 19.3% over the next year from the current level of 2.4%. As more speculative grade issuers revise down their profits and earnings expectations, we anticipate a surge in the number of ratings downgrades. Such moves are likely to presage an increase in the risk of default.***

Given the deepening recession in Europe and the sharp deterioration in credit quality, Moody's Default Research expects the European default rate to rise to 19.3% in the next 12 months from 2% in December. Given the severity of the current downturn in Europe, defaults may have further to rise than the current 12-month forecast suggests. European high yield default rates reached 35% in the early 1990's. Speculative grade credit quality has been resilient but it is starting to deteriorate sharply.

### European Issuance

***We expect overall European issuance to fall by 4.0% this year compared to 2008. The contraction in issuance would be worse if it not for government-related deals. The latter are expected to surge this year as governments increase fiscal spending and shore up their ailing banking sectors.***

Calmer financial markets have revived corporate debt issuance in the opening month. Top-rated European investment-grade issuances more than trebled in January, raising a total of \$71 billion, up from \$15.5 billion in the prior month. With calmer financial markets, corporate issuers are taking the opportunity to refinance maturing debt. Firms with a large portion of their debt in short-term maturities are also taking the opportunity to extend their debt maturity profile by retiring existing debt in favor of longer maturities.

This year sovereign issuance is also expected to take some of the slack in corporate and financial sector activity. Debt origination by governments is set to surge further this year, as they increase fiscal spending and shore up ailing banking sectors. In the UK, the second wave of initiatives to revive bank lending, including buying up £50 billion worth of high quality private sector debt, means more bonds will be issued.

Challenging capital markets and weak investor appetite for riskier assets mean overall European issuance is likely to remain weak this year. The European high-yield debt markets remain essentially closed as investors shun issuers with heavy debt loads. The recession is deepening, and corporate profits are expected to fall sharply. With corporate defaults expected to rise substantially this year, credit spreads are unlikely to recede soon, and borrowing costs could rise further. Firms are likely to turn to the debt markets only to refinance existing debt, rather than to finance expansion.

## Euro Area and U.K. Economic Outlook

***Flash estimates show growth plummeted in the euro zone in the final quarter of 2008. The latest economic indicators point to continued deterioration of activity, and we expect that the euro zone will contract by at least 2% this year before rebounding by 1.0% in 2010. In the UK, output is also likely to continue contract through 2009, despite aggressive action by Britain's policymakers. We forecast real GDP to shrink 2.9% this year, and to weakly rebound 0.6% in 2010.***

Flash estimates show growth plummeted in the euro zone in the final quarter of 2008. Output fell by 1.5% from the previous quarter, when it contracted by 0.2%. The economies of both Germany, France and Italy, the three largest in the euro region, contracted by the most in more than two decades in the three months to December. Germany's GDP fell 2.1%, France dropped 1.2%, and Italy fell 1.8%.

The region has suffered from several shocks. The financial crisis that began over a year ago intensified after the collapse of Lehman Brothers in September and led to a virtual freeze in activity in some money markets. Despite concerted efforts by governments and central banks in Europe and globally, financial markets remained distressed. Euro zone firms faced tight credit conditions and were squeezed by declining demand. Sales at home and abroad have been plummeting. Firms have responded by cutting production, investment, and their labor force. Exports have been the main engine of growth for the region in recent years. However, with key trading partners such as the UK also in recession, exports have fallen rapidly.

Worryingly, recent economic indicators suggest a further sharp euro zone contraction in the first quarter is likely. Rapidly deteriorating economic conditions in Europe are likely to pressure policymakers to take further action. Germany announced a second fiscal stimulus package in January. With inflation falling well below its medium-term target, the ECB is also likely to cut interest rates in the coming months.

The UK economy is in the midst of a deep recession. Real UK GDP fell sharply in the fourth quarter, plummeting 1.5% from the prior quarter, the biggest quarterly drop in output since 1980. The risks facing the outlook remain skewed to the downside. Despite central banks' massive injections of liquidity, the global financial system remains stressed. The main drivers of the continuation of the current downturn are expected to be further declines in private consumption and a sharp fall in business investment, particularly related to real estate. Despite the weaker British pound, exports are likely to contract in 2009 amid the deepening slump in global demand.

## The U.S. Economic Week

*By John Lonski, Ben Garber, and Chris Snyder, Moody's Capital Markets Research Group\**

*Estimates are consensus views. Release times are US Eastern Standard Time.*

### **March 2, Monday**

**Personal Income & Spending – January.** Time: 8:30 am. Forecast: Income: -0.2%, Spending: 0.4%. The relentless pace of layoffs is expected to drag personal income down for the fourth consecutive month in January. A fleeting bump in consumption is forecast for the past month thanks to higher energy costs and seasonal adjustment factors.

**Core Personal Consumption Expenditure Deflator – January.** Time: 8:30 am. Forecast: 0.1%. A modest bump in the core PCE deflator in January would leave this measure with 1.6% annual gain, falling within an agreeable range for policymakers. Federal Reserve projections for core PCE to grow at a 0.9% to 1.0% level in 2009 reflect significant downward revisions, and warn of heightened risk of deflation if appropriate stimulatory actions are not taken.

**ISM Manufacturing – February.** Time: 10:00 am. Forecast: 33.9. Cuts to production and inventories are struggling to catch up to the precipitous decline in new orders, implying a fifth straight sub-40 point reading for the ISM Manufacturing index. December's reading of 23.1 in the new orders sub-index is the poorest value in the 54-year history of this data series.

### **March 3, Tuesday**

**Pending Home Sales – January.** Time: 10:00 am. Forecast: -3.0%. Pending home sales in January are expected to partly reverse a December surge as expectations of falling prices suppress consumer demand. Stepped up government purchases of mortgage debt could be vital to lowering mortgage rates. Not only could this entice buyers, but it also presents refinancing opportunities that are likely to help stem foreclosures and boost discretionary income.

**Total Vehicle Sales – February.** Forecast: 9.6 million. February vehicle sales are forecast to be on par with January's twenty-six-year low. The March commencement of the Term Asset-Backed Loan Securities Facility (TALF) to restart the secondary consumer lending market can't come quickly enough for the reeling auto industry.

### **March 4, Wednesday**

**ISM Non-Manufacturing – February.** Time: 10:00 am. Forecast: 41.0. An unprecedented fifth consecutive month of negative readings in the ISM Non-Manufacturing survey will highlight the broad consumer and economic pain inflicted by the contracting service sector. The employment sub-index had never recorded a value under 40 until November 2008—a feat that was repeated in both of the following two months.

### **March 5, Thursday**

**Productivity & Unit Labor Costs – Q4 2008.** Time: 8:30 am. Forecast: Productivity: 1.6%, Unit Labor Costs: 3.4%. A sharp downward revision for fourth-quarter GDP necessitates unfavorable updates to sequential changes in productivity and unit labor costs. It remains an open question as to what sectors and technological developments will create the productivity gains that fuel the next economic growth cycle, with green technology being the most frequently cited potential savior.

**Initial Jobless Claims – Week Ending February 28<sup>th</sup>.** Time: 8:30 am. Forecast: 640,000. Recent multi-decade highs for initial jobless claims inflict a sharp downward bias toward forecasts for total layoffs. No turnaround for the economy can be foreseen until a muted pace of new jobless claims implies businesses are comfortable that they have reached an acceptable level of reduced costs and capacity.

**Factory Orders – January.** Time: 10:00 am. Forecast: -3.5%. Factory orders most likely will decline for the sixth straight month on the back of a -5.2% dive in durable goods orders. Higher energy expenditures in the non-durables segment partly mitigate the overall fall in demand

### **March 6, Friday**

**Employment Report – February.** Time: 8:30 am. Forecast: Nonfarm Payrolls: -640 thousand, Unemployment Rate 7.9%. Shockwaves from the global financial and economic crises are expected to lift the unemployment rate to 7.9%, its highest level in 25 years. The freefall in demand and lack of access to credit have brought on a stunning pace of payroll slashing. Bankruptcies by firms struggling to weather losses and facing large quantities of maturing debt are likely to carry the rise in joblessness past the technical end of the recession. The growing ranks of the current and potential unemployed reinforce banks' reluctance to lend, underscoring the benefit of the government's ability to manufacture demand.

**Consumer Credit – January.** Time: 3:00 pm. Forecast: -\$4.0 billion. Consumer credit is poised to contract in January, building on the total fourth-quarter decline of -\$19.7 billion. Probably prerequisite to a solid expansionary period of credit growth is the complete execution of the financial rescue plan.

## The European Economic Week

*By Christine Li and Kimberly Forkes and the European staff of Moody's Economy.com*

*Release times are Greenwich Mean Time*

Monetary policy announcements in the UK, the euro zone, and Switzerland are all due this week. We expect the Bank of England and the European Central Bank to each cut key monetary policy rates by 50 bp, to 0.5% and 1.5%, respectively. Despite looser monetary policy and improved fiscal support to the financial and industry sectors, recession is deepening in Europe and is likely to weigh on credit conditions throughout 2009.

### **Monday, 2 March**

**United Kingdom – BoE Lending to Individuals – January.** Time: 9:30 am. Forecast: £1.7 billion. Bank lending to individuals remains weak in the UK as the financial sector struggles with massive losses. Lending did bounce back to £2.2 billion in December, £0.6 billion higher than in November; however, this remained well below the year-ago levels. Banks are expected to keep a low profile over the medium term as they restore their balance sheets. House prices have further to fall this year. The government's new asset protection and insurance schemes could prove critical for the health of Britain's financial sector.

### **Thursday, March 5**

**Euro Zone – GDP – 2008Q4.** Time: 10:00 am. Forecast: -1.2% y/y. Preliminary estimates show euro zone output plummeted in the final quarter of last year as the region headed deeper into recession. The financial crisis—which intensified in September 2008 after the collapse of the U.S. investment bank Lehman Brothers—and tumbling exports have hit the euro zone hard. As recession deepens in the euro zone, the outlook for corporate credit quality remains poor.

**United Kingdom – Monetary Policy – March.** Time: 12:00 pm. Forecast: 0.5%. The Bank of England's Monetary Policy Committee lowered its key repo rate by another 50 bp at its February meeting, taking the monetary policy rate to a fresh record low of 1%. Since the central bank began its aggressive monetary easing campaign in early October, the key repo rate has been cut by a massive 400 bp. Another 50 bp rate cut is expected at the March meeting, but with the monetary policy rate rapidly approaching the zero bound, Britain's central bankers are running out of room to cut rates much further. The next step for Britain's central bankers will likely be to adopt a quantitative easing policy, creating central bank money to boost money supply.

**Euro Zone – Monetary Policy – March.** Time: 12:45 pm. Forecast: 1.5%. The ECB kept its key policy rate on hold in February at the historical low of 2%, as widely expected. However, annual inflation has eased well below the bank's medium-term target of 2%. High frequency data indicate the euro zone is likely to contract sharply in the first quarter of 2009, after GDP fell by 1.5% on a quarterly basis in the final three months of last year. This would add pressure on the ECB to cut rates in March.

### **Friday, March 6**

**Switzerland – Monetary Policy – March.** Time: 1:00 pm. Forecast: 0.375%. The Swiss National Bank has been on a monetary easing cycle since September last year in a bid to shore up economic growth. The interest rate target range is currently at 0% to 1% with an effective midpoint of 0.5%. The ceiling of the target range is expected to be lowered to 0.75% at the March monetary policy meeting, bringing the mid-point to 0.375%, the lowest rate since 2003.

## Rating Changes

*Significant rating actions taken the week ending February 27, 2009*

### Corporates

<b>Anglo American plc</b>		<b>Downgrade</b>
	18 Dec 08	23 Feb 09
Senior Unsecured	A3	Baa1
Short-Term Rating	P-2	P-2
Outlook	Review for Downgrade	Negative

As a result of the severe downturn currently experienced by the commodity sector, Anglo American's financial profile will likely deteriorate to a degree that will exceed the "through-the-cycle fluctuations" that can be accommodated by the A3 rating, even given the significant actions taken by management, including suspending the dividend. Considering the sharp global slowdown and highly uncertain economic outlook, we believe that the dramatic fall in commodity prices of the past few months is unlikely to reverse course in the short-term.

<b>Canwest Media, Inc.</b>		<b>Downgrade</b>
	8 Jan 09	23 Feb 09
Corporate Family Rating	B3	Caa3
Outlook	Negative	Negative

The downgrade reflects the company's very weak financial results and lack of financial flexibility. The rating action also anticipates that Canwest will look to restructure its business portfolio and debt structure as it addresses the impact of an adverse advertising environment and elevated financial leverage. Given ongoing credit market dislocation, there is the potential of additional adverse rating actions and much will depend upon ongoing negotiations with bank lenders.

<b>Continental AG</b>		<b>Downgrade</b>
	18 Dec 08	23 Feb 09
Corporate Family Rating	Ba1	Ba2
Outlook	Negative	Negative

A more severe than previously anticipated downturn in global automotive markets will likely not allow Continental to remain in line with the credit metrics required for its former Ba1 rating category. The negative outlook points to economic conditions that could still worsen, and which could affect the company's operating conditions at a time when it still needs to generate cash flow to deleverage. The need to address the upcoming refinancing debt maturity of EUR 3.5bn due in August 2010 from the VDO acquisition debt also continues to weigh on the rating outlook.

<b>Fiat S.p.A.</b>		<b>Downgrade</b>
	15 Jan 09	23 Feb 09
Corporate Family Rating	Baa3	Ba1
Outlook	Review for Downgrade	Negative

The downgrade follows significantly negative free cash flow in FY2008, leading to a material deterioration in Fiat's financial flexibility. We think the markets will remain challenging in 2009, with a significant drop in volume and limited prospect for a meaningful recovery in 2010. Operating profitability and cash flow generation will likely remain very weak in the intermediate term. A recovery of Fiat's credit metrics in line with an investment-grade rating will likely take more time than can be accommodated for that rating level.

**Kirin Holdings Co., Ltd.****Outlook Change**

	20 Feb 08	23 Feb 09
Senior Unsecured Outlook	Aa3 Stable	Aa3 Negative

The change in rating outlook is prompted by our growing concern that Kirin Holding's policy to continue debt-financed acquisitions in the current economic environment may constrain financial flexibility. Kirin Holdings has made several debt-financed acquisitions over the past few years, such as Kyowa Hakko for JPY 167 billion and National Foods Limited for approximately JPY 294 billion. As a result, the company's reported debt has increased to over JPY 660 billion.

**MGM Mirage****Downgrade**

	3 Feb 09	23 Feb 09
Corporate Family Rating Outlook	B1 Review for Downgrade	B3 Review for Downgrade

The downgrade reflects the difficulty the company faces in shoring up its liquidity profile. We estimate that internally generated cash, net proceeds from the pending sale of Treasure Island, together with a recent draw on its revolving credit facility and cash on hand, will be barely sufficient to fund operations -- including CityCenter obligations -- and required bond maturities through year-end 2009. MGM faces bond maturities of approximately \$300 million and \$800 million in the second and third quarters of 2010, respectively. Additionally, the inability of the MGM and its joint venture partner, Dubai World, to raise the remaining \$1.2 billion of the targeted \$3.0 billion debt raise for CityCenter has exacerbated the MGM's liquidity situation.

**Nissan Motor Co., Ltd****Downgrade**

	14 Jan 09	25 Feb 09
Senior Unsecured Outlook	A3 Review for Downgrade	Baa2 Stable

The two-notch downgrade is driven by significantly impaired profitability and cash flow at Nissan, due in turn to the severe market conditions in the global auto industry. We are concerned that the company's profitability will remain under pressure during FYE3/2009 and FYE3/2010. The stable outlook incorporates our view that Nissan will have a sufficient cushion on its balance sheet to withstand the current difficult market environment and will recover its profitability over the next few years.

**Sensata Technologies B.V****Downgrade**

	10 Jul 08	25 Feb 09
Corporate Family Rating Outlook	B3 Stable	Caa2 Negative

The downgrade is a consequence of the economic downturn and an expectation of further erosion in Sensata's credit metrics due to the deterioration in its sensors and controls businesses. The company's liquidity profile is also under stress. The global automotive industry, from which the company earns about 50% of its total revenues, is undergoing a severe global contraction, and we believe that it will remain weak at least through 2009. The anemic U.S. economy is also negatively affecting the telecommunications and domestic housing markets, important sources of revenues for Sensata's controls business. Operating margins are likely to come under more pressure as the company takes restructuring charges.

Thermo Fisher Scientific		Outlook Change
	15 Nov 06	25 Feb 09
Senior Unsecured Outlook	Baa2 Stable	Baa2 Positive

The positive outlook reflects Thermo Fisher's continued solid execution and operating performance in a difficult economic environment, strong credit metrics for the rating category, and the stability of its business model. The ratings benefit from the company's large size, consumable nature of a significant portion of revenues and substantial geographical and product diversification. While the company has continued to expand operating margins over the two years since the Fisher Scientific merger, the ratings continue to be constrained by an acquisitive strategy and substantial share repurchases. Other credit risks include substantial technological and obsolescence risks in many of the company's products, particularly those that involve more advanced technologies.

Williams Companies, Inc.		Outlook Change
	6 Nov 08	23 Feb 09
Senior Unsecured Outlook	Baa3 Negative	Baa3 Stable

The change follows the company's announcement that it will not pursue the separation of one or more of its principal business units. The decision to remain a diversified natural gas company has eliminated the event risk that was reflected in our negative outlook. While the lower commodity price environment will lead to significantly reduced earnings and cash flows in 2009, Williams is well positioned in its Baa3 rating to weather this sector downturn.

## Banks & Non-Bank Finance

Citigroup Inc.		Downgrade
	16 Jan 09	27 Feb 09
Senior Debt	A2	A3
Senior Subordinated Debt	A3	Baa1
Junior Subordinated (Citigroup Capital Trust Vehicles)	A3	Baa3 (negative outlook)
Preferred Stock	Baa3	Ca
Short-Term	P-1	P-1
FDIC-Guaranteed Debt	Aaa	Aaa
Outlook	Review for Downgrade	Stable

Citibank N.A.		Downgrade
Deposits	Aa3	A1
Bank Financial Strength	C-	C- (negative outlook)
Baseline Credit Assessment	Baa1	Baa2
Short-Term	Prime-1	Prime-1
Outlook	Review for Downgrade	Stable

The downgrade of senior and subordinated ratings is driven by our expectation that the current level of government support notwithstanding, Citigroup will emerge from the current economic crisis with a different mix of core businesses and a smaller scale, which could diminish its relative importance to the U.S banking system over the long run. The confirmation of the BFSR reflects the fact that the recapitalization announced Feb. 27 and the government's eligible asset guarantee better position the company to face a number of near-term financial and operational pressures. The multi-notch downgrade of the preferred stock rating incorporates the expected loss resulting from the deferral of dividends on these non-cumulative instruments, which we believe could last for several years.

<b>Fionia Bank A/S</b>	<b>Downgrade/Confirmation</b>	
	10 Dec 08	24 Feb 09
Deposits and Senior Debt	A3	A3
Subordinated Debt	B1	C
Short-Term	P-2	P-2
Bank Financial Strength	D-	E
Outlook	Review for Downgrade	Stable

The E BFSR -- the lowest possible rating on Moody's scale -- reflects our understanding that, following the transfer of its assets and senior liabilities, Fionia Bank will cease its banking operations and will consequently hand in its banking license. The confirmation of the deposit and senior debt ratings is underpinned by the fact that the liabilities, including deposits and senior debt, will be transferred to a new bank that will be controlled by the government-owned company, Finansiel Stabilitet. Fionia Bank will remain as a holding company owning the shares in the new bank and its name is planned to be changed to Fionia Bank Holding A/S. The downgrade of the subordinated debt rating under the MTN programme to C follows the decision not to transfer these liabilities to the new bank. The bank does not have any subordinated debt outstanding under the rated MTN programme.

<b>SLM Corp.</b>	<b>Under Review for Downgrade</b>	
	4 Nov 08	27 Feb 09
Long-Term	Baa2	Baa2
Outlook	Negative	Review for Downgrade

The rating action follows the announcement of President Obama's proposed budget on February 26, which calls for the replacement of the FFELP lending program by the Federal Direct Lending Program with services such as loan servicing and possibly originations being outsourced to "competitive, private providers," possibly including SLM. The announcement creates uncertainty regarding SLM's business plan going forward. During the review, we will seek to clarify how a termination of the FFELP lending program would affect the company's earnings capacity and business mix, including potential ramifications for the company's private credit business and operating cost reduction program.

<b>Swedbank AB</b>	<b>Downgrade</b>	
	10 Dec 08	27 Feb 09
Long-Term	Aa3	A1
Bank Financial Strength	C+	C-
Outlook	Negative	Negative

<b>AS Hansapank</b>	<b>Downgrade</b>	
	10 Oct 08	27 Feb 09
Deposits	A1/P-1	Baa2/P-2
Bank Financial Strength	C-	D
Outlook	Negative	Negative

The downgrade of Swedbank reflects our expectation of a substantial increase in impairments in the Baltic countries and to a lesser extent in Sweden. As a result, the bank's financials -- particularly earnings generation capacity, asset quality and capitalization -- are expected to deteriorate over the short-to-medium term, thereby positioning the bank at the lower end of its C BFSR range. The downgrade of the long-term ratings reflects the weaker BFSR, but also continues to incorporate the very high probability of systemic support.

The downgrade of AS Hansapank's financial strength rating reflects the bank's significantly weakened asset quality and the continuing difficult environment in the Baltic region. The bank has a relatively large exposure to the property and construction sector in the three Baltic countries, which is likely to lead to further weakening asset quality and higher loan loss provisioning needs over the next couple of years. The downgrade of the deposit and senior debt ratings reflects the weaker intrinsic financial strength of the bank, as well as downgrade of the bank's ultimate parent, Swedbank.

## Insurance

Allianz		Affirmation
	2 Sep 08	26 Feb 09
Senior Debt	Aa3	Aa3
Insurance Financial Strength Outlook	Aa3	Aa3
	Stable	Stable

The affirmation follows the company's announced full-year net loss of EUR2.4 billion, driven by a EUR4 billion net profit on the continuing operations and a EUR6.4 billion net charge on the disposal of Dresdner Bank. Notwithstanding the significant losses recorded for 2008, we affirm the group's ratings in the expectation that excellent profitability from the core operations will continue to offset any future investment losses and global recessionary pressures.

## U.S. Public Finance

Correction: Amherst College (MA)		Outlook Change
	22 Dec 08	18 Feb 09
Series K-1	Aaa	Aaa
Series F,H,I,J-1,J-2,K-2	Aaa/VMIG1	Aaa/VMIG1
Outlook	Stable	Negative

**Last week's edition of Weekly Credit Outlook listed the wrong rating for Amherst College's Series K-1 bonds. The correct rating is Aaa.**

Bi-State Development Agency (MO)		Review for Downgrade
	15 Nov 07	20 Feb 09
Sales Tax Appropriation Bonds	A2	A2
Outlook	Stable	Review for Downgrade

The review for downgrade reflects the significant challenges that the agency faces, including accelerated bank bond payments, as well as sizeable potential exposure to derivatives and SILO/LILO (sale-in-lease-out/lease-in-lease-out) termination payments. Operations for the agency are also under pressure, with voters rejecting a sales tax increase in November 2008, declines in pledged Prop M sales tax revenues for FY09, and the county reducing its appropriation of non-pledged sales tax revenues in May 2008.

Catholic Health East (PA)		Outlook Change
	17 Jun 08	26 Feb 09
Revenue Bonds	A1	A1
Outlook	Stable	Negative

The outlook has been revised to negative from stable following the downturn in FY 2008 financial performance and decline in liquidity. Failure to reach the FY 2009 budget, along with further liquidity declines, will likely result in a rating downgrade.

Palomar Pomerado Health (CA)		Downgrade
	07 Mar 08	26 Feb 09
Revenue Bonds	A3	Baa1
Outlook	Negative	Negative

The downgrade reflects a recent history of operating difficulties, a decrease in liquidity, and ongoing risk relating to the construction and operation of a very substantial capital project. The outlook remains negative. The scope and scale of PPH's master facilities plan, and PPH's significantly leveraged balance sheet, underscore the need for management to maintain improved operating performance. Furthermore, an additional revenue bond issuance planned within the year likely will stress PPH's credit profile further.

Palomar Pomerado Health Care District (CA)		Downgrade
	26 Nov 08	26 Feb 09
General Obligation Bonds	Aa3	A1
Outlook	Stable	Stable

The downgrade reflects continued weakening in the district's debt structure. It also reflects the district's current financial position, revenue bond debt burden, and project risk. The large size and diversity of the district's tax base, currently suffering from the downturn in the residential real estate market, continues to be incorporated in the current rating.

### Gas Project Revenue Bonds

On February 20th, we downgraded to Ba1 from Baa1 Central Plains Energy Project's (NE) Series 2007A and Tennessee Energy Acquisition Corp.'s (TN) Series 2006A. The guaranteed investment agreements (GICs) for these transactions are issued by MBIA Inc. (Ba1) and there are surety bonds supporting the GICs from MBIA Insurance Corporation (B3), which are available in the event MBIA Inc. fails to pay under the GICs. Therefore, we are relying on the higher of the two ratings (MBIA Inc. and MBIA Insurance Corporation) of the entities obligated to pay under the GICs.

Alternately, the Baa1 rating of Tennessee Energy Acquisition Corp.'s Series 2006C bonds were placed under review for possible upgrade. Pursuant to the recent restructuring of MBIA's portfolio of insurance policies into MBIA Insurance Corp (B3) and MBIA Illinois (Baa1 on watchlist for upgrade), MBIA's data shows that the surety bond for these bonds has been reinsured by MBIA Illinois.

## Infrastructure

DTE Energy Center, LLC		Downgrade
	15 Dec 08	27 Feb 09
Senior Secured	Baa3	Ba1
Outlook	Review for Downgrade	Review for Downgrade

The downgrade reflects the increased risk to bondholders resulting from the precarious state of Chrysler, the parent of the project's sole customer, notwithstanding the guarantee from Daimler North America Holding Corporation (DNAHC) of Chrysler's obligations. The rating of Chrysler Automotive LLC was recently downgraded to Ca with a negative outlook reflecting the severe pressure that the decline in U.S. automotive demand and the shift in consumer preference to smaller vehicles have had on the company's liquidity position. The rating action also considers the deteriorating financial condition of Daimler AG, the parent of DNAHC. Daimler's outlook was revised to negative on February 18, 2008. The continuing review will consider the impact on the project's rating if Chrysler announces plans to shutdown any of the facilities at which the project assets are located and/or if it is forced to seek bankruptcy protection, which we estimate to have a 70% probability of occurring even if additional assistance from the government is forthcoming.

Enel S.p.A. & Subsidiaries		Review for Downgrade
	22 May 08	23 Feb 09
Senior Unsecured	A2	A2
Short-Term	P-1	P-1
Outlook	Negative	Review for Downgrade

Endesa S.A. & Subsidiaries		
Senior Unsecured	A3	A3
Outlook	Negative	Review for Downgrade

The reviews follow the announcement that Enel will buy the remaining 25.01% of Endesa from Acciona for EUR11.1 billion. This acquisition will give Enel 92.06% control of Endesa, with the balance held by the market. The review of Enel reflects its weak positioning at the current A2/P-1 rating level. The significant increase in group leverage could result in downward pressure on the rating unless this deterioration is sufficiently offset by other measures such as capex reduction, divestments or other capital-bolstering exercises. The review of Endesa reflects the fact that the ratings are likely to become closely aligned with that

of Enel. While the company has recently been less leveraged than Enel, full control of the company's cash flows and hence dividends will allow Enel to determine Endesa's capital structure in the future.

<b>Energy Future Holdings Corp</b>		<b>Review for Downgrade</b>
	3 Nov 08	24 Feb 09
Corporate Family Rating	B2	B2
Senior (Guaranteed) Unsecured	B3	B3
Senior Unsecured	Caa1	Caa1
Outlook	Negative	Review for Downgrade
<b>Texas Competitive Holdings</b>		
Senior Secured First Lien	Ba3	Ba3
Senior (Guaranteed) Unsecured	B3	B3
Senior Unsecured	Caa1	Caa1
Outlook	Negative	Review for Downgrade

The review for possible downgrade primarily reflects the material decline in natural gas commodity prices, market heat rates, and declining hedge effectiveness due to increased basis risk over the past several months. These trends are negatively affecting the cash flow generating ability of Texas Competitive Electric Holdings, and ultimately, Energy Future Holdings. The current material degradation in macro economic factors, combined with the declining fundamentals associated with weaker commodity prices, increases the risks associated with servicing over \$40 billion of debt.

<b>Vattenfall AB</b>		<b>Affirmation</b>
	27 Jul 06	23 Feb 09
Issuer Rating/ Senior Unsecured	A2	A2
Senior Subordinate	A3	A3
Outlook	Stable	Stable
<b>Vattenfall Treasury AB</b>		
Senior Unsecured	A2	A2
Senior Subordinate	A3	A3
Guaranteed Junior Subordinate	Baa1	Baa1
Capital Securities		
Commercial Paper	P-1	P-1
Outlook	Stable	Stable
<b>Nuon Power Generation BV</b>		<b>Review for Downgrade</b>
	14 Sep 07	27 Feb 09
Senior Unsecured	A3	A3
Outlook	Baa2	Review for Downgrade

The ratings of Vattenfall and its subsidiaries were affirmed following the announcement that the company has made an all cash offer of EUR10.3 billion to acquire 100% of Nuon NV's generation and supply operations. Vattenfall has built significant flexibility in its financial profile for its rating level. The acquisition is expected to be largely debt financed and will absorb this financial headroom, bringing Vattenfall's financial profile more in line with the parameters expected for the current rating category. The acquisition is consistent with Vattenfall's strategy, aimed at establishing the company as a leading European energy player, and would enable the acceleration of its investment strategy focused on renewable energy sources. The transaction would also potentially improve Vattenfall's balance between generation and supply activities and would increase the strength and scale of its operations, thus diversifying the company's generation portfolio by geography, market and fuel mix.

At the same time, we placed the A3 senior unsecured issuer rating of Nuon Power Generation BV on review for possible downgrade. Splitting out the higher-risk generation and supply entity from the regulated activities of Nuon NV could result in negative rating pressure for an entity focused exclusively on competitive activities. The rating review will consider the stand-alone credit strength of the company including the final capital structure and further developments with regard to business strategy. Nonetheless, it will also factor the potentially positive benefits of ownership by the larger and more diversified electric utility.

## Sovereign

Greece		Outlook Change
	11 Jan 07	25 Feb 09
Government Foreign Currency	A1	A1
Government Local Currency	A1	A1
Foreign Currency Bank Deposit Ceiling	A1	A1
Foreign Currency Bond Ceiling	Aaa	Aaa (Eurozone)
Short-Term Rating	P-1	P-1
Outlook	Positive	Stable

Even though Greece is relatively less affected by the global downturn than many of its peers, the outlook change from positive is a recognition that a toll has been taken on the Greek economy, halting growth and reversing the decline in public debt ratios of previous years. While an upgrade to the Aa range is unlikely in the next 12-18 months, the stable outlook means the ratings are well positioned at A1.

Ukraine		Review for Downgrade
	21 Oct 08	23 Feb 09
Government Foreign Currency	B1	B1
Government Local Currency	B1	B1
Foreign Currency Bank Deposit Ceiling	B2	B2
Foreign Currency Bond Ceiling	Ba3	Ba3
Outlook	Stable	Review for Downgrade

The review reflects concerns about persistent political uncertainty that clouds prospects for an orderly resolution of banking problems during the economic downturn. The review will focus on the policy direction for dealing with current stresses and analyze the prospects for stabilizing the economy and preventing further deterioration over the medium term.

## Structured Finance

### U.S. Subprime RMBS

We have raised our loss expectations for U.S. subprime residential mortgage-backed securities (RMBS) issued between 2005 and 2007. As a result, we have placed 7,942 tranches of subprime RMBS with an original balance of \$680 billion on review for possible downgrade. The revised loss projections for 2006 vintage subprime pools are within the range of 28% to 32% of the original balance of such pools, whereas our previous estimate was 22%. For 2005 and 2007 pools, losses are expected to range from 12% to 14% and 33% to 37% of original balance, respectively. These higher loss expectations are the result of the continued deterioration in home prices, rising loss severities on liquidated loans, persistent elevated default rates, and progressively diminishing prepayment rates throughout the sector. The updated loss estimates will reflect current home price projections from Moody's Economy.com.

Resulting rating actions will vary by vintage, but it is likely that the vast majority of mezzanine and subordinate certificates currently rated B or above would be downgraded to ratings of Caa or below, particularly for bonds issued in 2006 and 2007. Actions on senior bonds will differ based on payment priority and protection relative to projected losses. Given the level of losses currently being projected, a majority of senior certificates will likely be downgraded below investment grade. Many are expected to be downgraded to Caa or below, particularly longer duration bonds from 2006 and 2007.

### U.S. Alt-A RMBS

We have concluded our review of Alt-A residential mortgage backed securities (RMBS) issued in the U.S. from 2005 to 2007. The table below summarizes all rating actions taken during the course of this review, from January 29 to February 26.

	Aaa	Aa	A	Baa	Ba	B	Caa	Ca	C	Total Ratings
Original Rating	Aaa	4.9% (359)	4.0% (296)	12.8% (944)	12.7% (931)	22.2% (1,632)	35.9% (2,639)	7.2% (527)	0.3% (19)	7,347
	Aa	1.2% (27)	1.4% (30)	10.6% (233)	14.7% (324)	11.9% (262)	32.6% (719)	15.7% (346)	11.9% (262)	2,203
	A		0.1% (1)	3.9% (72)	6.5% (120)	9.4% (174)	48.4% (895)	15.6% (288)	16.2% (299)	1,849
	Baa			0.4% (5)	3.8% (52)	4.7% (65)	41.4% (573)	19.2% (266)	30.6% (423)	1,384
	Ba				0.5% (6)	1.0% (11)	30.9% (346)	30.9% (346)	36.6% (410)	1,119
	B					0.1% (2)	3.4% (61)	13.4% (239)	83.0% (1,476)	1,778
	Caa						0.6% (4)	9.0% (61)	90.5% (616)	681
	Ca								100.0% (1,897)	1,897
	C									0
<b>All ratings 1/29 - 2/26</b>										<b>18,258</b>

### Collateralized Loan Obligations (CLOs)

We are continuing our review of CLOs following revisions announced on February 4<sup>th</sup> to our default probability assumptions, the treatment of ratings on review for possible downgrade or with a negative outlook among the corporate credits in the underlying portfolio, and the calculation of the Diversity Score. The table below summarizes the rating actions taken this week as a part of this review.

	Aaa	Aa	A	Baa	Ba	B	Caa	Ca	C	Total Ratings
Original Rating	Aaa	75.0% (9)	16.7% (02)	8.3% (01)						12
	Aa		62.5% (5)	25.0% (2)	12.5% (1)					8
	A			9.1% (1)	81.8% (9)	9.1% (1)				11
	Baa					85.7% (6)	14.3% (1)			7
	Ba					12.5% (1)	87.5% (7)			8
	B						100.0% (6)			6
	Caa							100.0% (1)		1
	Ca									0
	C									0
<b>Week ending 2/27</b>										<b>53</b>

### ABS Collateralized Debt Obligations (CDOs)

We have downgraded a number of structured finance CDOs that consist of significant exposure to one or more of Alt-A, Option-ARM and subprime RMBS securities; CLOs; or CMBS to reflect upwardly revised loss expectations on these asset classes. In addition, the rating actions also incorporate revisions in three key parameters we use in our models for rating SF CDOs: asset correlation, default probability and recovery rate. The changes to these assumptions were announced last December. Rating actions taken in this asset class over the past week are summarized in the table below.

Original Rating	Aaa	Aa	A	Baa	Ba	B	Caa	Ca	C	Total Ratings
	Aaa		36.0% (9)	40.0% (10)	16.0% (4)			8.0% (2)		
Aa		4.2% (1)	25.0% (6)	12.5% (3)	29.2% (7)	16.7% (4)	12.5% (3)			24
A				23.1% (3)	7.7% (1)	15.4% (2)	53.8% (7)			13
Baa				24.0% (6)	8.0% (2)	20.0% (5)	20.0% (5)	20.0% (5)	8.0% (2)	25
Ba						25.0% (1)	50.0% (2)		25.0% (1)	4
B							63.6% (7)	9.1% (1)	27.3% (03)	11
Caa							6.7% (1)	26.7% (4)	66.7% (10)	15
Ca									100.0% (13)	13
C										0
<b>Week ending 2/27</b>										<b>130</b>

### Corporate Synthetic Collateralized Debt Obligations (CDOs)

We are continuing our review of corporate synthetic CDOs begun on January 15th, when we announced updated assumptions for default probability, asset correlation, and other credit indicators such as rating reviews and outlooks. The table below summarizes the actions taken as a result of this review over the past week.

Original Rating	Aaa	Aa	A	Baa	Ba	B	Caa	Ca	C	Total Ratings
	Aaa		45.2% (38)	31.0% (26)	11.9% (10)	10.7% (09)	1.2% (01)			
Aa		1.7% (1)	20.3% (12)	44.1% (26)	22.0% (13)	10.2% (6)		1.7% (1)		59
A			2.7% (1)	13.5% (05)	43.2% (16)	24.3% (09)	16.2% (6)			37
Baa				1.6% (1)	17.7% (11)	19.4% (12)	38.7% (24)	22.6% (14)		62
Ba					3.5% (2)	3.5% (2)	57.9% (33)	35.1% (20)		57
B							12.2% (5)	87.8% (36)		41
Caa							2.9% (1)	97.1% (33)		34
Ca										0
C										0
<b>Week ending 2/27</b>										<b>374</b>

## Research Highlights

*Notable research published the week ending February 27, 2009*

### Corporate Finance

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#### **INDUSTRY OUTLOOK: U.S. and Canada: Wireless-Services Industry**

We expect that revenues, earnings, and cash flows of most operators will remain strong over the near term, even as subscriber growth slows. We therefore do not expect significant credit rating changes in the sector over the next 12 to 18 months. However, margin pressure is likely to develop longer term as the market approaches saturation and new subscriber growth stalls. This report is one of a four-part series of six-month updates on the U.S. and Canadian telecom industries, including diversified telecom providers, competitive local exchange carriers, and incumbent local exchange carriers.

#### **INDUSTRY OUTLOOK: U.S. Competitive Local-Exchange Carriers**

Our negative outlook is based on our view that the weakened U.S. economy will all but eliminate revenue growth for many U.S. competitive local-exchange carriers in the coming year, pushing some toward covenant violations. Given the relatively low EBITDA margins and steep competition from the incumbent phone and cable companies, the industry will have a hard time scaling back costs or capital spending plans to offset lost revenues if the economic weakness persists longer than expected. Our ratings reflect these concerns, but could come under pressure if the economy worsens more than expected. This report is one of a four-part series of six-month updates on the U.S. and Canadian telecom industries, including diversified telecom providers, wireless-services, and incumbent local exchange carriers.

#### **ANNOUNCEMENT: Moody's revises the Aerospace and Defense Industry Sector Outlook to Stable from Positive**

The move to a stable from a positive outlook reflects a number of increasing uncertainties, including:

- The availability of the considerable financing required for planned airplane deliveries.
- Declining air passenger traffic, which reduces the need for new airplanes.
- How certain large U.S. defense programs in development or production could fare after review by the new administration.
- How the revised practices for weapons acquisitions programs and the policy statements from the upcoming U.S. Quadrennial Defense Review (in 2010) could affect the overall returns of the defense contractors.

Supporting the stable outlook are record high backlogs at the commercial airplane producers Boeing and Airbus, as well as long-term procurement and services contracts at most major defense contractors. Defense outlays in the U.S. will be at a record level for this year. The major contractors also have some financial flexibility to manage through a downcycle.

### Financial Institutions

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#### **SPECIAL COMMENT: Calibrating Bank Ratings in the Context of the Global Financial Crisis**

This report provides additional guidance on the meaning of our bank ratings and how our ratings methodology operates in the current environment, which is characterized by continued scarcity of private liquidity and capital resources and a high degree of government support for the banking system. We continue to apply our existing methodologies to provide a rank ordering of bank credit risks. However, we have determined that some refinements of the weights and relative importance attached to certain rating factors within our methodologies are warranted. As part the process of calibrating our bank ratings, we are putting more emphasis on support and on specific drivers of banks' intrinsic safety and soundness -- such as capital adequacy and core earnings -- that best reflect the realities of this enduring credit crisis. Senior debt and deposit ratings for most major banks in advanced economies remain investment grade, due to the high level of government support.

However, bank financial strength ratings are more likely to experience increased volatility -- and initially, downgrades.

#### **INDUSTRY OUTLOOK: Australian Credit Unions**

The negative outlook applies across the sector, as funding pressures increase from strong retail deposit competition, and credit quality weakens in line with the current economic environment. Larger credit unions with robust balance sheets are likely to withstand increasing funding pressures and erosion of net interest margins, but smaller institutions may not survive the challenging environment ahead without further consolidation. Consolidation in the industry remains the most dynamic of all Australian deposit-taking institutions.

## **U.S. Public Finance**

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#### **SPECIAL COMMENT: MBIA Illinois' Rating to be Applied to Municipal Bonds**

MBIA's recent restructuring of its financial guaranty insurance business means that MBIA Illinois assumes the risk associated with municipal exposures in contrast to MBIA Insurance Corp, which insures the remainder of the portfolio. We have reviewed the reinsurance agreement between MBIA Illinois and MBIA Corp, and we will assign ratings to the reinsured municipal securities based on the higher of (a) the insurance financial strength rating of MBIA Illinois (Baa1 under review for possible upgrade); or (b) the published underlying rating. Due to the large volume of affected transactions, it may take some time for us to update impacted ratings in our ratings database

## **Infrastructure**

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#### **SPECIAL COMMENT: 2009 U.S. Public Power Electric Utility Sector Outlook**

The outlook for the public power electric utility sector remains stable through 2009 and into 2010. We expect most public power utilities will be able to manage through the recessionary pressures, but the length and severity of the economic downturn could present further credit challenges. The maintenance of the stable outlook will depend on how well these utilities adapt not only to changing a changing economy, but to regulatory conditions as well. Expected carbon emissions regulation could also be a major cost issue, and access to liquidity is constrained by the stressed credit markets.

## **International Public Finance**

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#### **SPECIAL COMMENT: Mexican States Face Funding Challenges**

Given the current macroeconomic outlook for Mexico and related risks to the federal government budget, federal transfers -- the primary source of revenue for Mexican states -- are expected to contract slightly in real terms during 2009. This follows a prolonged period of strong growth in transfers, which has contributed to the build-up of budgetary spending pressures in certain states. We do not anticipate that this cyclical funding slowdown will exert downward pressure on ratings in 2009, though exceptions may emerge in cases where there are long-term negative trends in credit metrics not caused by the decrease in transfers.

## **Structured Finance**

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#### **SPECIAL REPORT: 2008 Review and 2009 Outlook: U.S. CREF Surveillance**

More downgrades than upgrades will occur in 2009. Rapid economic deterioration will stress property cash flows over the next few years, increasing term default risk. For loans with near-term maturities, refinance risk will also rise as cash flows deteriorate and higher risk premiums are required to secure financing. Where appropriate, we expect servicers to provide extensions to enable borrowers to ride out this period of illiquidity, reducing losses. All in all, we anticipate peak delinquencies for recent vintage commercial mortgage-backed securities (CMBS) to be in the 10% to 12% range, which at an average loss severity of 45% implies expected losses of around 5%. We are proactively addressing increased systemic risk through ratings sweeps of U.S.

conduit, fusion, large loan, and single borrower deals, and commercial real estate collateralized debt obligations (CRE CDOs). The sweeps will be done by March 31, 2009. Thereafter, we expect a period of relative ratings stability.

#### **ABS Market in Japan: 4Q 2008 Market Review including 2008 Review and 2009 Outlook**

This report discusses factors that in 2009 are likely to impact collateral performance of Japanese ABS, which includes auto loan, installment sales loan, credit card purchase, card cash advance, consumer finance loan, real-estate-backed SME loan, and SME loan receivables. Individual obligors are being adversely affected by the shrinking consumer finance loan market, which is being driven in part by the introduction of loan amount caps. Market players had already factored in these changes in ABS deals backed by credit card receivables and consumer loan receivables. However, the downturn in the business environment and the growing uncertainty over employment are compounding the affects of these legal changes. Asset types, including auto loan receivables, that have until now been relatively less sensitive to the macroeconomy may be negatively affected.

#### **SPECIAL REPORT: 2008 Review and 2009 Outlook: CMBS Market in Japan**

This report provides overviews of new issues, the performance outlook for underlying assets, and rating implications. In particular, the rapid growth in the number of delinquent loans is a key topic. The delinquency rate (by loan balance) grew from 0% to 1.32% in 2008. Thus, the number of negative rating actions for CMBS exceeded positive actions in 2008 -- for the second time (since 2003). We expect the increasing delinquency at balloon under current financial turmoil to be one of the reasons for negative actions, expected to increase in 2009. In 2009, underlying loans maturing will reach roughly JPY 750 billion.

Report Number: 115032

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