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Update on Moody's evaluation of the Monoline Financial Guarantors: 12/6/07

Yesterday, Moody's Investor Service provided a current assessment of the stability of the monoline financial guarantors credit ratings. By applying one or more stress test models to the bond insurers, Moody's has reiterated their position that FGIC and AMBAC are "somewhat likely" to exhibit a capital shortfall. In addition, Moody's has downgraded their outlook for MBIA and now considers the insurer to be "somewhat likely" to also exhibit a capital shortfall.

The credit ratings will be affirmed when Moody's believes there is capital adequacy and strength in the insurer's "business franchise". If Moody's makes the determination that the current rating no longer reflects the long-term financial strength of the entity then the monoline insurers could be downgraded without a formalized review. Even if there is the potential benefit of "credible capital remediation", a downgrade still remains a distinct possibility.

Assessment of portfolio risk to reward

Since our November 8th, 2007 communication on this topic, the municipal bond market has been in the process of re-pricing credit risk. Specifically, the tax-exempt market is differentiating in yield terms between "insured bonds" carrying high underlying ratings and lesser quality bonds.

For the last several weeks we have also witnessed an increase in stories that have related to the insured municipal bond mutual fund sector. Namely, that insured municipal bond mutual funds will become "forced sellers" of any bond that is wrapped by a guarantor whose credit rating is cut to "AA". After canvassing our network in the "street", we have learned that these fears may be overblown. Many prospectuses for the insured mutual funds afford the portfolio manager an opportunity to continue holding a bond that loses its top credit ranking if at the time of purchase of the security, it carried a "AAA" rating.

As anticipated, the market has also returned to some sort of normalcy. After the uncertainty which sent municipal yields higher, the market has been rallying on the back of declining treasury yields and strong retail investor participation.

Potential Opportunity

This environment breeds opportunity as the days of trading bonds as generic "AAA" may be behind us. The additional yield that used to go to the insurers can flow through to the investor in an asset class that has experienced a less than one-half of one percent default rate[1] since the 1970s. This includes the municipal high yield sector, and the largest municipal bond default in history: WPPSS (Washington Public Power Supply System).

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[1]Source: Moody's Investor Service

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