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## Moody's Downgrades New Jersey to A1, Outlook Remains Negative

On May 13, Moody's lowered its rating on the general obligation (G.O.) bonds of the State of New Jersey by one notch, to A1 from Aa3, and maintained a negative outlook on the state's rating. Moody's downgrade comes two weeks after Fitch also lowered its rating on New Jersey by one notch, to A+. S&P previously lowered its G.O. rating on the state in early April, to A+ from AA-. As a result of the downgrades of the state's G.O.s, most New Jersey bonds secured by a pledge of annual appropriations by the State Legislature were also notched down by the rating agencies. Both Moody's and Fitch currently maintain negative outlooks on the state's rating, while S&P has a stable outlook.

### State of New Jersey

	Ratings	Outlooks
General Obligation bonds	A1/A+/A+	negative/stable/negative
Appropriation bonds*	A2/A/A	negative/stable/negative
New Jersey Qualified School Bond Program	A2/A	negative/stable

\* includes State of New Jersey certificates of participation as well as bonds issued by the New Jersey Economic Development Authority, the New Jersey Building Authority and other state agencies.

Sources: Fitch Ratings; Moody's; S&P

New Jersey has thus far failed to act to make the necessary long-term changes to its budget to place it on more stable financial footing going forward. We believe that further ratings deterioration is possible in the intermediate term absent significant state action and that market values of New Jersey state and agency bonds could suffer as a result. **Ascent is not currently adding any holdings of bonds secured by payments from the State of New Jersey, and will not do so until we see concrete evidence of structural improvements in the state's financial position.** However, we continue to view the State of New Jersey as a high quality issuer that presents little payment risk to investors over the long term. For this reason, we continue to hold existing positions in New Jersey State and agency bonds. Furthermore, we continue to selectively add local New Jersey bond issues to client portfolios, including local school district bonds enhanced through the Qualified School Bond Program, that are not dependent on the state for credit support or the majority of their revenues, as we expect market prices for these bonds to remain strong regardless of the

developments with the state. Careful credit selection can uncover local issues that offer high stand-alone credit quality.

The downgrades of New Jersey reflect the increasing pressure on the state budget. New Jersey recently disclosed that state revenue collection in the current fiscal year (FY2014, ending June 30) are unexpectedly some \$800 million below projected levels, creating a substantial budget shortfall that will have to be filled prior to the fiscal year's end. Because the state already had to use a number of one-time measures just to bring the FY2014 budget into balance based on the previous revenue expectations, it will be difficult for state officials to identify ways to close the gap in the current fiscal year. The unexpected shortfall also further complicates the process of crafting the FY2015 budget. The substantially lower level of state revenues now expected for the full year FY2014 create a lower revenue baseline from which the state must start for FY2015.

New Jersey faces a number of ongoing structural challenges that will have to be addressed to maintain strong credit ratings over the long term. These include:

- Economic performance that has lagged the nation as the state has recovered from the recession;
- A history of overly optimistic revenue projections that have left state officials scrambling to fill unexpected mid-year budget gaps;
- A reliance on one-time revenue measures (i.e., capturing savings from debt restructurings, securitizing state tobacco funds, shifting funds from other agencies to the state general fund, etc.) that have not addressed the underlying imbalance between ongoing revenues and expenditures;
- High debt levels;
- Very low cash balances that create the potential for liquidity strains in the event of unforeseen revenue shortfalls or unplanned expenses; and
- Underfunded state pension programs that result in high annual pension funding costs, though some reforms have been incorporated.

Over the coming weeks, the rating agencies will very closely follow the ongoing disclosure of the state's FY2014 revenues, budget balancing efforts, and the development of New Jersey's FY2015 budget. If there are further negative revenue surprises or if state fails to effectively manage its budget for the current and coming fiscal year, it is possible that one or more of the rating agencies could take negative action on the state's credit ratings. We do not, however, expect rating to fall below A2/A/A levels in the intermediate term. Despite its current financial problems, New Jersey's credit quality remains solidly anchored by:

- A very large and diverse state economy;
- Relatively high wealth levels (measured by income, wealth and property values); and
- Broad executive powers to reduce budget expenditures without legislative approval.

We will continue to closely monitor developments with New Jersey's FY2014 results and proposals for a FY2015 budget and their potential impacts on the state's credit rating.



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