Special Comment

March 2003

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Credit Implications of the War in Iraq for U.S. Corporate Issuers

Summary

Based on remarks made in a teleconference on March 24, 2003, this Special Comment examines the credit impact of the war in Iraq on U.S. corporate issuers. After a general look at the war's implications for the U.S. economy, it discusses the following industries: oil and gas, chemical, airlines, aerospace & defense, auto manufacturing, and lodging & leisure.

In general, the credit ratings for most U.S. corporations are unlikely to be further pressured by the war in Iraq provided there is a relatively expedient resolution to the conflict. Companies in industries most likely to experience fluctuations in demand or pricing as a result of the war are already rated at levels that take into account the impact of at least a short conflict.

In the oil and gas sector, companies are already being rated in part according to their ability to handle the extreme volatility in prices. Although the Iraqi war is a major geopolitical event, it comes on top of other major operational and geopolitical forces long at work on the oil sector and its ratings. While the drop in oil prices since the outbreak of the war seems premature, they are likely to stabilize at around $25-$30 per barrel WTI in the near term and in the low $20s for 2004, barring another major economic contraction.

The volatility in oil prices has in turn affected other industries, like chemical manufacturers, for which the current drop only means that they will be unable to implement planned increases to pass through higher costs already incurred. However, many of these companies were already downgraded in 2002 and the outlook for the industry was modestly negative going into 2003.

Similarly, the impact of war on the airlines has preceded its outbreak, as the result of both higher fuel prices and lower demand. While the conflict in Iraq may be the proximate cause of failure of one or more airlines, it will not likely be the primary factor for any defaults, absent a prolonged conflict. Rather, the causes of these will be the combination of high costs and a collapse in yields driven by fundamental overcapacity.

Defense contractors, in contrast, will see a slight uptick in revenues as a result of the war, as certain expendables need replacement. Additional revenues should approximate one-half billion dollars for each day of the war.

The anticipation of war and elevated threat of domestic terrorism have already impacted the leisure industries. While most ratings are currently adequately positioned, a prolonged conflict or domestic terrorist event could easily pressure ratings. In 2001 gaming showed its resilience during troubled times, although the Las Vegas market is vulnerable to drops in air travel. Even should the war be short, recovery in lodging and the cruise industry will be slow.

For the major auto manufacturers, a short war should not add pressure to Ford and GM's ratings, but, with negative outlooks, they may be vulnerable if scenarios prove worse case.

Moody's Investors Service
Global Credit Research

Economic Outlook

(Comments By John Lonski – Moody's Chief Economist)

External Shock Risks Weigh on Economy

At this point in time, the downside risks facing the U.S. economy exceed the upside potential. Worry over the potential costs of terrorist reduction and the possibility of disruptive terror attacks has weighed on both U.S. and global economic activity for more than a year. The approach and now the realization of hostilities against Saddam Hussein's regime have added to the long-lived loss of economic activity to what might be best termed external shock risks – external shock and not geopolitical shock, because external shock risks would also include the possibility of more devastating terror attacks.

Anything which adds to risk aversion will curb the growth of expenditures. Consumer spending, capital expenditures, and employment are now lower than they would be otherwise, because of heightened external shock risks.

Consensus Expects 2.6% GDP Growth

Consensus expectations of an imperceptible rise in the annual rate of real GDP growth from 2002's lackluster gain of 2.4% to 2003's projected rise of 2.6% implicitly assume that the removal of Hussein and the establishment of a new Iraqi government will not prove to be especially costly in terms of lives lost, the price of oil, new terror attacks, and/or political instability elsewhere. However, the forecast of 2.6% growth for 2003 allows for the continuation of a loss of economic activity to above average terror risks. The consensus probably allows for the threat of, but not the realization of, major terror attacks within the United States.

Regarding crude oil, although the price of crude has been climbing higher again, it still trails its 2003-to-date average. We shouldn't forget that the U.S. economy did receive a special lift when the price of a barrel of crude remained under $20 per barrel from November 2001 through January 2002. As crude oil prices have subsequently risen, economic activity has suffered.

Risk of War Going Poorly, More Terror, Should Not Be Discounted

On the other hand, a military confrontation with Iraq that goes poorly in terms of casualties, higher oil prices, more terror attacks, and/or political unrest outside of Iraq represents the most likely trigger mechanism for a double-dip recession. The odds of such an occurrence remain significant, perhaps hovering at about 30%. In turn, an elevated level of risk aversion subtracts from business activity. Note also that in the case that we have this worst case scenario materialize, the economic program of the Bush administration could suffer greatly.

Anything that puts additional downward pressure on what are already relatively low levels of consumer and business confidence could do significant damage to an already faltering U.S. economy. If failed efforts at regime change send stock prices sharply lower again, well below 7,000 say, a double-dip recession may be unavoidable.

The consensus looked for a first quarter slowing of economic activity, where the year-over-year increase drops from the 2.9% of 2002's fourth quarter to around 2% in the first quarter of 2003. The good news is that thereafter, the annual increase of real GDP is expected to rise and possibly reach 3% by 2003's final quarter. These existing forecasts of economic activity are very much in line with other forecasts that look for year-over-year percentage increases of corporate revenues and profits to decline from 2002's final quarter to 2003's first quarter, but then move higher thereafter.

Monetary and fiscal stimulus should lend buoyancy to the U.S. economy later in 2003. What have been the lowest mortgage yields since the early 1960s have sent applications for mortgage refinancings to new record highs. The consumer spending of 2003's second half ought to benefit from the spectacular surge by mortgage refinancings of the last nine months. Moreover, despite sharply higher home prices and slower income growth and because of extraordinarily low mortgage yields, January's index of housing affordability was the highest since early 1999. This brings attention to how the successful resolution of the Iraqi matter could spark a significant upturn by home sales in the not too distant future.

Consumer Confidence Down For Reasons Beyond War

Nevertheless, we have to be aware that consumer confidence is sharply lower for reasons other than external shock risks, the most important of which is a dearth of job opportunities. In addition, consumer spending's upside potential remains hemmed in by well above average household debt service burdens and by a much lower ratio of household sector net worth to consumer spending, with a drop in net worth arising from the loss of wealth due to stock price declines, where this loss of wealth was dearer than, or outweighed by, the additions to wealth stemming from home price appreciation.

Although consumer spending stands to receive additional support from lower borrowing costs and a new round of tax cuts, its outlook remains marred by the prolonged absence of jobs creation. Consumer spending being comparatively brisk paced, despite the loss of jobs, serves as one of today's great macro-economic oddities. The record shows a strikingly strong correlation between capital spending and employment. When capital spending rises, so does employment and vice versa. Unfortunately, after rising up from recent lows, various indicators of capital spending will probably soften in response to heightened external shock risks. Likewise, employment's recovery may have to wait.

The behavior of the equity market will have much to say about economic performance. A lasting recovery by capital spending probably requires a broad based recovery of share prices. Moreover, low rates of capacity utilization highlight the need for industry consolidation via M&A. If M&A is going to take root and rise from its now very low level, there has to be a firming of the equity market.

Even with Best Case Scenario Growth Will Be Lower Than in Latter 1990s

Suppose that perceived external shock risk drops significantly. Not only does Saddam Hussein exit from power without disruptive aftershocks, but other significant progress is made at diminishing terror risk. In this case, real GDP could grow by as much as 3.2% annually in 2003. However, that 3.2% rate of growth would pale in comparison with the 4.1% average annual rate of growth that held from 1997 through 2000. We have to remember that the US economy is most unlikely to return to its very rapid growth of the late 1990s, mostly because of the low probability of anything comparable to the investment-spending boom of the late 1990s returning any time soon.

In conclusion, an expeditious regime change in Iraq would benefit both the U.S. and the broader world economy. However, a return to the much faster growth of the late 1990s is not imminent. We would do well if the U.S. investment spending annual increase averages a third of what it averaged during the period from 1993 through 2000. Even a best case scenario in terms of reduced external shock risks may lift US real GDP growth to nothing higher than 75% of its pace during the four years ended 2000.

For now, the U.S. economy must do without the short-lived boost that was supplied by the investment-spending boom of the late 1990s. In conclusion, these downside risks will continue to outweigh the U.S. economy's upside potential.

Oil & Gas

(Comments by Andrew Oram – Vice President/Senior Credit Officer)

Just More Volatility in an Industry That's Used to It

Although the Iraqi war is a major geopolitical event, it comes on top of other major operational and geopolitical forces long at work on the oil and gas sector, and on sector ratings. For 144 years, oil has been a highly capital intensive classic boom/bust commodity. Its only time of relative price stability was a roughly 20-year stretch ending in 1973 when OPEC effectively seized control of pricing from the Seven Sisters. The OPEC cartel's effort to manage this rambunctious commodity's price has been a geopolitical and imperfectly managed toboggan ride ever since.

The run-up to this war has simply added amplitude to the current price up-cycle, but could, as is the way of high commodity prices, amplify the next down-cycle too. However, since hyper-volatile prices are basic to oil and gas, our ratings already endeavor to factor in how well each oil and gas issuer is postured to build lasting strength through the cycles. It's also worth noting that even the price stability under the oil majors was illusory and came at a cost. Over time, unnaturally low oil prices distorted the price signals vital to ensuring suitable reinvestment of capital within both the sector and the broader world economy.

In the run-up to this war, a war risk premium of greatly debated proportion was priced into already high prices supported largely by strong gasoline and winter distillate demand, OPEC discipline, and curtailed Venezuelan and now Nigerian production. As we expected, oil prices fell sharply on the outbreak of war as the market began to fear oversupply on abundant Saudi crude in storage in the Caribbean and Middle East, on a normal seasonal slowdown in demand, and on negligible damage so far to Iraqi oilfields. But the pace and magnitude of the correction seems premature to us.

Reduced, But Still Strong Prices Near-Term

Still, regardless of how large the premium was and when it finally blows off, we see reduced but still strong oil prices over the near-term relative to the historic mean. As long as economies avoid the aforementioned contraction scenarios, near-term oil price support is seen in tight commercial petroleum inventories, sufficient demand, OPEC discipline, and Nigerian production curtailment. A cool summer would, however, dampen demand. While much is yet to unfold about this war, we see near-term West Texas Intermediate prices settling towards $25 on modest demand growth, or

closer to $30 with stronger growth and/or more problems in Nigeria or still-simmering Venezuela. For 2004, we'd expect WTI in the low $20's range.

Longer-term, in addition to normal down-cycle forces, much depends on Saudi Arabia's willingness to continue supporting OPEC's targeted $22 to $28 basket price (and the historic mean) by continuing to absorb potentially increasingly intolerable market share loss by restraining Saudi production. When the Saudi's last lost patience in 1997 and 1985, oil averaged less than $15 the following year. We'll also be keeping an eye on whether more aggressive post-war exploration and development of Iraq's petroleum potential, after 20 years of under investment, further pressures the Saudi's willingness to play the swing producer role for OPEC cohesion.

Up-Cycle Cash Infusion

With all that as context, it is fair to say that the principal benefit of the recent war price premium was an augmented up-cycle cash infusion for the upstream sector, buying time for some weaker performing oil and gas producers to either reduce debt or try to turn around poor finding and development results. Conversely, the premium augmented the severe oil and gas cost pressures faced by many other industry sectors, as explored in some of the industrial discussions that follow.

Looking back a bit further, though, the major integrated and independent oil and gas producers have benefited from up-cycle prices since 2000, lasting that long largely on OPEC production restraint. But the ratings generally remained constrained by the increasingly hard time this mature sector has in replacing production with reserves of comparable risk, quality, cost, and life. For most producers, a dollar doesn't go as far as it used to in finding, developing, and completing lasting reserve volume. The producers' ability to productively reinvest cash flow and internally fund that investment varies across the board. Strong prices have been sufficient to keep the leverage and rating equation in balance for most, but some issuers - large and small - have been falling behind.

Contract Drilling, Oilfield Services – Producer Spending May Increase as Prices Become Clearer

Moving to contract drilling and oilfield services, the up-cycle cash infusion enjoyed by producers has not yet flowed proportionally to drilling and services. Producers rightly exercised tougher capital spending restraint in the face of considerable post-war price risk and increasingly mature and less robust drilling prospects. Producers' capital budgets represent the lion's share of the drilling and service sector's revenues and drive that segment's asset utilization and cash margins. But producers have built some dry powder, and increasingly visible 2003 and 2004 prices may boost their spending later this year.

The war added to price volatility and forced producers to reassess assumptions about longer-term prices. The oil majors make massive capital investment commitments into very long-term planning horizons, and while near-term volatility is not a dominant factor affecting planning, any concern about OPEC's ability in the long run to support historic mean prices would give them pause and, perhaps, even keep some powder dry for possible investment in post-war Iraq. On the other hand, both near-term volatility and expected long-term mean prices do impact the timing and scale of capital spending by independent producers, as well as the capital allocation mix across their operating regions. The regions where the timing of oilfield spending is most affected by price volatility are the North American land, shallow-water Gulf of Mexico, and North Sea markets. Assuming all goes well with the war, the large drilling and oilfield services firms may also benefit by participating in rejuvenating Iraqi oil fields and exploring for new reserves.

Risk to Refiners May Also Have Dissipated

Lastly, the war's principal risk to independent refiners may have dissipated as well, though we expect more volatility. After the damage of terrible 2002 refining margins, and shouldering massive capital spending for low sulfur diesel and gasoline capability, leveraged refiners faced the added strain on working capital and liquidity caused by very high and steeply backward-dated oil prices. The sharp price decline as the war started probably caused inventory losses, but it also moderated liquidity pressures. A very cold winter and continued strong gasoline demand has also greatly tightened the market to yield seasonal record first quarter crack spreads. We do continue to see risk to deep conversion margins if OPEC has to cut production, but this could be offset if Iraqi heavy production ramps up again and lighter Nigerian crude production is curtailed for a meaningful period of time.

Chemical Industry

(Comments by John Rogers – Vice President/Senior Credit Officer)

War's Greatest Impact: Oil Price Volatility and Uncertainty in Demand

For the chemical industry, the greatest impact of the war is the potential for further volatility in oil and gas prices and, the impact of uncertainty on industrial and consumer demand. At the start of the year we had a moderately negative outlook on the industry's ratings; any significant reduction in industrial or consumer demand in 2003 would result in a more negative view on ratings in the industry.

Petrochemical Producers Subject To Largest Negative Impact

The recent volatility in oil and gas prices will have the greatest negative impact on basic petrochemical companies, including Dow, CPC, Lyondell/Equistar, Nova, and Huntsman. The substantial decline in oil and gas prices since the start of the war will prevent these companies from recovering the higher costs experienced over the past month and a half. In addition, it will prevent the implementation of price increases that have already been announced for March and April. Hence, margins will be negatively impacted in the first and second quarters. This is a sector that could see some additional negative rating actions, especially if weaker demand in 2003 increases the likelihood that peak earnings margins and cash flows in 2004-2005 would be substantially below prior peak levels. Significant new international capacity is expected to start-up in 2005-2006.

Other companies that have seen a significant negative impact from higher feedstock prices include inorganic chemical producers: chlor-alkali (Dow, Olin, Georgia Gulf), bromine producers (Great Lakes), soda ash (General Chemical, Solvay, and FMC) and TiO2 (DuPont, Millennium, Kronos, Kerr-McGee and Huntsman). Also, commodity chemical and plastics producers like Celanese and Eastman will see a significant negative impact in the first half of the year. To a lesser degree, companies like Cabot, DuPont, Lubrizol, and Rohm & Haas will be hurt by increases in costs. Chlor-alkali & TiO2 producers will fair better than petrochemical producers due to higher capacity utilization rates. Hence, they are more likely to be able to recover higher costs and may experience improving margins in the second half of 2003 versus prior year levels.

Though Less So, Specialty Chemical Companies Still Affected

We anticipate that most specialty chemical companies will be negatively impacted to a lesser degree than their commodity brethren. However due to the war, demand remains suppressed across much of the industry. Lower demand will negatively impact profitability in the first quarter for the vast majority of companies in the industry, with the exception of the following specialty companies: Sigma Aldrich, IFF and Valspar.

Industrial Gas Producers Likely to See Modest Profit Reduction

U.S. Industrial gas producers have been very aggressive in seeking price increases and not just energy surcharges. The net impact is likely to be a modest reduction in profitability in the first quarter. Given the recent fall-off in gas prices, combined with the permanent nature of the price increases, these companies have the greatest potential to expand margins over the remaining nine months of 2003. Praxair, Air Products, and Airgas are the largest beneficiaries here. We expect that international producers - Air Liquide, BOC, Linde and Messer - are likely to see a more modest benefit.

Commodity Petrochemical Producers to Bear Brunt of Oil Price Volatility

Unless the war is concluded by the end of April, the industry is likely to experience a weaker second quarter than in 2002. We believe that seasonal demand will be reduced, limiting both margins and the ability to recover further spikes, or temporary increases, in oil and gas prices throughout the industry.

Given this scenario, the companies that will absorb the brunt of further volatility in oil and gas prices will be the commodity petrochemical producers. Even though roughly 10% of U.S. olefin capacity will be off-line in April and May due to turnarounds, we do not anticipate that these turnarounds will have a significant positive impact due to increases in inventory, which will limit any supply-side shortfall. Margins are not likely to improve significantly, even if oil and gas prices continue to decline. The one exception here may be Equistar, for which their flexi-cracker capacity could provide a $50 million benefit in the second quarter if oil prices continue to ease and gas prices remain north of $5/mmBTU.

In summary, the war is exacerbating concerns over further weakness in financial performance for the vast majority of companies in the industry. Negative rating changes are more likely for commodity chemical companies and highly leveraged companies, especially if the U.S. economy weakens further in 2003 as a direct result of elevated oil and gas prices or an extended war in the Middle East.

Airlines

(Comments by Richard Bittenbender – Vice President/Senior Credit Officer)

Twin Impact – Increased Costs, Declining Revenues – Already Felt

The airline industry is among those that are most directly affected by the war, both the immediate war in Iraq and the ongoing war on terrorism. The impact of the war in Iraq has already been felt, well in advance of the actual initiation of hostilities, through the increased price of fuel - crude oil peaked briefly at about $40 per barrel - and a decline in passengers - bookings were off 10% to 20% even in advance of the beginning of the conflict.

These two factors - increased costs and declining revenues - are the primary concerns at this point. On the cost side, the good news is that many carriers were substantially hedged against fuel cost increases for the first quarter, and crude oil prices have recently come off their highs and were back down to about $27 per barrel on the Friday after the war started. Most carriers had substantial portions of their first quarter fuel consumption hedged, United and US Airways being exceptions. However, the percentage of fuel hedged for most airlines tails off quite sharply for the remainder of the year, and fuel costs going forward are a concern.

Of greater concern are revenues and the huge decline in bookings. We can only speculate, like everyone else, how quickly passengers will begin to travel again under various conflict and economic scenarios.

Financial Fragility Leaves Carriers Vulnerable

The real concern is the financial fragility of most airlines, particularly in the United States. Many, if not most, U.S. airlines have experienced two years of losses and a resulting deterioration in liquidity. All rated airlines in the U.S. have increased their lease-adjusted debt levels since 9/11, and are generating less operating cash flow. Most are finding their liquidity and financial flexibility under extreme stress, and are considered by Moody's to be very fragile financially. While at the end of the day, the conflict in Iraq may be the proximate cause of the failure of one or more airlines, absent a prolonged conflict, it is not expected to be the primary factor determining their fate. That is the result of losses due the combination of high costs and a collapse in yields driven by over capacity.

Each airline is differently affected due to route structure. More domestic routes and less leisure business is probably better. As for a liquidity profile, more is definitely better. Non-U.S. carriers have not seen the same degree of financial difficulties that have affected U.S. carriers in the past two years, and generally maintain adequate liquidity profiles. Nevertheless they are under many of the same pressures, although from a financially stronger position.

Airlines that would seem to be less affected due to domestic route structures will probably be companies like Southwest, AirTran, ATA, America West and Alaska. Fee-for-service carriers will probably not be immediately affected and could benefit from a downsizing of the average size of aircraft, but it is Moody's opinion that even these carriers are at some risk due to overall capacity reductions.

Entities with better than average short-term liquidity would be Southwest, America West, Alaska, Northwest, and Delta.

Really weak carriers may well file for bankruptcy court protection because of other factors; the war may only accelerate their filing(s), not actually cause it. Some have speculated that the benefits of bankruptcy are so great that if several airlines avail themselves of this restructuring opportunity, all will be forced to do so - at least among the big legacy hub and spoke carriers. We don't think this is inevitable. The two things that are most flexible in bankruptcy are labor costs and capital costs.

Many airlines have announced substantial cuts in capacity and workforce, and we note that American and United are in active negotiations with their labor groups for substantial reductions in labor costs. Airlines in general have been cutting costs for some time now, and we have seen those both in and out of bankruptcy ask for substantial reductions in wages and/or amendments to long-standing work rules. We've also seen that most carriers have been able to go back to labor groups, even outside of bankruptcy, now that the standard has been set inside of bankruptcy, to at least ask for concessions. So bankruptcy may not be necessary to achieve that end.

While capital costs are an important factor, the amount of any logical reduction, even in bankruptcy, is not sufficient to make the bankrupt carrier substantially more competitive. With the costs and loss of control that bankruptcy brings, we don't see management teams seeking that option. While Moody's sees cost reductions in general as being critical for strengthening short-term cash flows, labor cost reductions alone will, in most cases, only bring the airlines back to break even operating levels. In order to become more viable and financially stronger entities, either a stronger revenue stream or additional cost cuts will be necessary.

Finally, there has been a good deal of speculation regarding the likelihood of the U.S. government providing additional or modified support to the domestic airline sector. We think there is a reasonable probability that the U.S. gov-

ernment will provide some assistance to the airline industry, particularly in the event of a prolonged conflict. However, there also remains a good deal of political resistance to "saving the industry", and that resistance will be a limiting factor. We don't know in what form the aid will manifest itself, and there are a wide variety of ideas including delays of certain tax payments, reimbursement of security costs, and even reopening the Air Transportation Stabilization Board loan guarantee program. This decision will come only if it becomes evident that the impact on passenger traffic from the war is going to last a while longer, with very severe consequences to the industry as a whole.

Aerospace & Defense

(Comments by Tassos Philippakos – Senior Vice President)

Impact Negative for Civil Aircraft Builders, Positive for Defense Contractors

The impact of the war in Iraq should be negative for civil aircraft manufacturers and positive for defense contractors. Most companies have exposure to both segments, and the implications for any specific company will be a function of its business mix. Our ratings incorporate the consequences of a short conflict period in which the coalition's objectives are met. On the defense side, which accounts for more than half of the global aerospace/defense industry's revenues, the impact should be moderately positive from two perspectives - near-term and intermediate-term.

Near-term the impact is moderately positive as it creates demand for unmanned air vehicles known as UAVs, consumption of expendables such as missiles, bombs, and artillery rockets, as well as an increasing need for spare parts due to the high utilization of aircraft and other armaments. The additional revenues related to all these items are estimated at around half a billion dollars daily. Thus, if we assumed that the war would last only 10 days (we are notably already there) and all consumed and lost armaments are replaced one-for-one – which may not be the case, at least near-term – then the additional near-term revenue for U.S. and British defense contractors would be estimated at approximately $5 billion.

The Maximum $500 Million-a-Day Boost

Under this rather optimistic scenario, and given the fact that sales for U.S. and British defense contractors well exceed $150 billion, the maximum additional increase in the sector's sales – beyond the expected 6%-to-7% growth rate primarily for the U.S. defense contractors– would be another 3.3%. If the war lasts longer, then the industry's revenues may benefit at most by $500 million per day. Companies that may benefit the most are the primary producers of missiles, bombs and artillery rockets, such as Lockheed Martin, Raytheon and Boeing, as well as the producers of unmanned aircraft such as Boeing and Northrop Grumman.

The other positive side for the defense sector is that the war solidifies the perception of real threat, which makes it politically easier for President Bush to obtain Congressional approval for his planned increases in the U.S. defense budgets for the next 3-4 years. Furthermore, the perception of threat not only for the United States, but also for other countries, could also act as a catalyst for some growth in the European defense budgets, which have been stagnant.

Impact on Civil Sector Totally Negative

For the civil sector, however, the impact is totally in the negative direction. As discussed, the airlines have been and will be further affected by this war, and their financial condition and overall performance may further weaken. Under these circumstances, deliveries of commercial aircraft will – as we have anticipated – decline further from the 2002 levels, while the regional aircraft deliveries will be under some pressure. Thus, the deliveries of commercial aircraft by Boeing and Airbus will decline, while the regional aircraft deliveries of Bombardier and Embraer may experience some pressure, but not as much as that confronting Boeing and Airbus.

The uncertainty so far, during both the period before the war and the war itself, have also impacted the demand for business jets, which is expected to decline further from the already poor levels of 2002. Soft global economic conditions have reduced the appetite for non-essential capital spending for corporate jets. Just recently, Textron announced that the "current economic and geopolitical situation is affecting business jet demand much more severely than expected." Companies that may be affected in this sector include Textron, Bombardier, Raytheon's corporate jets business and General Dynamics' Gulfstream.

Most Businesses Are Mixed

In most cases, aerospace/defense companies have exposure to both civil aircraft and defense markets. Therefore, the impact of this war, to the extent that it is a short and successful one, will be rather balanced. However, if the war is protracted and/or the world experiences significant terrorist attacks, then companies with significant exposure to civil aircraft business like Textron, EADS, and, to some degree, Boeing, may feel more pressure on their credit quality.

Lodging & Leisure Industries

(Comments by Peggy Holloway – Vice President/Senior Credit Officer)

Recovery in Some Segments Will Be Slow, Regardless of the Pace of the War

This discussion will cover several of the leisure industries, including lodging, gaming, and cruise lines. It assumes that the war with Iraq will be relatively short, and that the negative impact of this geopolitical risk on the leisure industry will be relatively short lived. However, having said that, we believe that a recovery in certain sectors, particularly lodging and cruise lines, may take some time to emerge given the weak economy, as well as the elevated threat of domestic terrorism in the US. Additionally, recent economic data, such as lower GDP growth expectations, declining consumer spending and confidence, and anemic corporate profits, are likely to pressure near-term demand, while recent cost increases for insurance and employee benefit costs will keep downward pressure on earnings through 2003.

Gaming May Be Most Resilient, Though Vegas Vulnerable to Drops in Air Travel

Moody's outlook for the industry remains stable. Moody's believes that the gaming industry will generally be the segment of the leisure industry least impacted by the war in Iraq due to the fact that the majority of gaming markets around the US are drive-to markets that were only marginally impacted for a relatively short period after the events of 9/11, as well as the fact that gaming has become a routine leisure activity for many consumers, and one that provides an outlet, if you will, to the heightened tension many in the US are feeling.

Las Vegas is the most vulnerable market since a larger portion of its visitors arrive by air; therefore, the increased terror threat here in the US may cause a fall off in visitors arriving by plane. However, initial reports from several Las Vegas operators indicate that so far the war has not resulted in any significant level of cancellation activity or net bookings. Therefore, at this point in time, Moody's does not anticipate the need to take any rating actions in the gaming sector due to the war or increased domestic terrorism. However, those companies with significant Las Vegas strip exposure, such as MGM Mirage and Mandalay, and those companies with negative rating outlooks could face rating pressure should the war be more prolonged or if a terrorist event occurs on US soil. We note that generally speaking most investment grade, as well as leveraged gaming companies, generate sufficient levels of cash flow to fund capex and dividends – and have sufficient liquidity in the form of available credit under committed revolving credit facilities – to meet near-term obligations.

Lodging Rebound Will Be to Low Levels – Industry Outlook Negative

In the lodging industry, the anticipation of the war has already caused revenue per available room (RevPAR) to drop in recent weeks, as business travelers in particular are clearly deferring travel plans. We expect RevPAR will weaken further as the war unfolds, but will rebound to levels existing prior to the conflict once the war is either over or appears in control. Nevertheless, Moody's does not anticipate normalized travel demand to resume until the underlying economic conditions improve. As a result, Moody's overall outlook for the industry is negative; however, our outlook for ratings varies by company, segment and sector. Moody's believes the war in Iraq will further delay the recovery in the lodging sector, and the impact on ratings is very much dependent on how well positioned any individual company is within its rating category. On a brighter note – the industry's supply growth has slowed significantly – leading us to believe that once a recovery begins, the industry will rebound relatively quickly.

Capacity Expansion Will Slow Cruise Industry Recovery

The situation in the cruise industry is similar to that of the lodging industry. Cruise pricing has worsened in anticipation of the war. Exacerbating this situation is the fact that the industry continues to experience significant capacity expansion – so unlike the lodging industry – we expect the cruise industry will recover more slowly.

All in All, Impact Already Felt, and Most Ratings Should Have Room to Cope

In summary, the lodging and leisure industries have already been negatively impacted in anticipation of the war, and in response to the elevated threat of domestic terrorism. Generally, we believe that most companies rated by Moody's in these industries have some room within their existing ratings to absorb the expected temporary negative impact of the war in Iraq, and also have generally acceptable levels of liquidity to enable them to weather the storm. However, if the war is more prolonged than expected or if a terrorist event occurs here – we are likely to see rating pressure.

Auto Manufacturing

(Comments by Bruce Clark – Senior Vice President, given in response to a listener's question)

Negative Outlooks for Ford and GM Suggest Vulnerability to Surprises

Moody's ratings for Ford Motor Company (Baa1 rating; negative outlook) and General Motors Corporation (A3 rating; negative outlook) contemplate an operating environment that is not burdened by disruptions stemming from any conflict in Iraq. Major assumptions for this environment include U.S. light vehicle shipments of about 16 million, and net price retention of negative 2.25%.

If the conflict is short and decisive, and is not accompanied by dramatically alarming events such as the release of chemical or biological weapons or a significant terrorist attack, then the events in Iraq should not contribute to added pressure on the ratings of either company. However, a scenario entailing a quick victory and no major terrorist attacks may be becoming less likely. Just as important, consumer anxiety arising from events in the Middle East could persist through the intermediate term. Consequently, there appears to be an increasing likelihood that unit shipments for 2003 will come in below 16 million units and that the resulting competitive pressures will contribute to further deterioration in pricing. This does not bode well for either company given rating outlooks that are already negative.

Conclusion

Because it had been widely anticipated, the war in Iraq should not lead to changes in corporate ratings, which are already positioned to reflect its most likely impact. Ratings generally incorporate the negative effects of the war, such as extreme volatility in oil and gas prices, and reduced travel. Only defense contractors are likely to see a revenue boost from the war, and only a moderate one. An unexpectedly long war – or a major U.S. domestic terrorist attack – would likely have rating implications for many industries since it could conceivably add to, if not entirely trigger, a double-dip recession in the latter half of 2003.

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Report Number: 77759

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