July 2, 2009

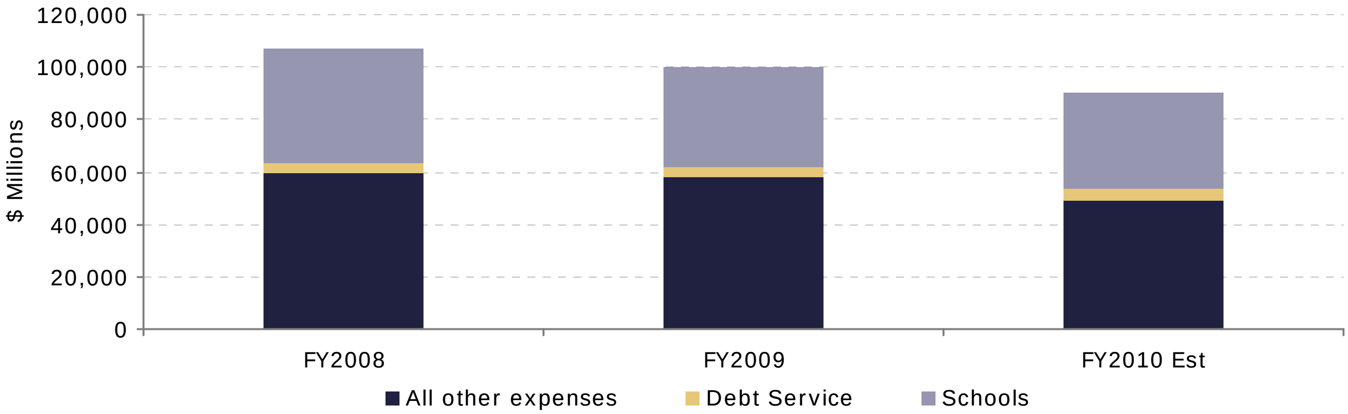
California Bulletin

Yesterday the Governor of California declared a fiscal emergency and called a special legislative session which by law can not adjourn until the budget has been passed. In the absence of an approved budget, the state will begin paying bills with IOUs and state Controller John Chiang has warned that the state may run out of cash entirely by the end of July. This commentary will address certain credit fundamentals including payment of debt service, the state's cash position, the budget and how we are positioning our clients' portfolios.

Debt Service

As mandated by the state Constitution, general obligation debt service has the second highest payment priority after public school funding. This is an uncommon feature in public finance and one which provides very strong bondholder protection. Following general obligation debt service in priority are lease revenue bonds, internal borrowing repayment, employee payroll, Medi-Cal Claims and repayment of any revenue anticipation notes. The lower priority of payments includes tax refunds, vendors, social service payments to counties, and a number of other social service and health programs. Clearly, while this creates stress at the programmatic level, bondholders still have the second highest claim on state revenues. Based on the most recent estimates for FY2010, public school payments equal $38.8B (43% of spending) which leaves $53.5B of revenue to cover $4.5B of debt service. In the chart below, total state expenditures are shown ranked by Constitutional priority. Note the considerable level of expenditure cushion (labeled "All other expenses" in the chart) which would be required to be cut before debt service is jeopardized. So while in a political crisis a late debt service payment is possible, the chart below highlights the degree to which the state's financial resources makes this unlikely from a fundamental perspective.

Expenses Ranked by Constitutional Priority



Source: California Department of Finance

California's state debt burden is the 10th highest in the country on a per capita basis, an amount that is manageable for a state with its economic resources. The demonstrated ability to pay plus the constitutionally mandated priority of debt service payments should give investors comfort that the state will ultimately make debt service payments in full.

Cash Position

The state's most recent cash flow statement (which is a monthly statement, although internal state figures are tracked on a daily basis) indicates a very modest $2.1 billion cash balance at the end of July. However, since this estimate was prepared, revenues have continued to significantly underperform, making this forecast already out of date. The Controller is now estimating a cash deficit by the end of July, requiring the state to begin paying bills with IOUs. While the media headlines referring to the IOU issuance clearly indicate fiscal stress, bondholders should be assured that IOUs would only be issued for expenses which are clearly defined as lower priority per the Constitution. IOUs will be issued until the state is able to access the short term note markets. A note sale would enable the state to bridge the cash flow imbalance which regularly occurs over the summer / fall months. Recent press reports indicate this note sale will need to be at least $10 billion and can only take place when the state passes a budget.

Budget

There is no doubt that the state is experiencing a very severe recession with May unemployment at 11.5%, extensive residential housing foreclosures throughout the state and income tax and sales tax down 20% and 12%, respectively, from the prior year. However, much of the budget crisis in the state can be traced to two longstanding factors: the effects of voter-approved Constitutional amendments, and the requirement for a two-thirds majority to pass the state's budget or raise taxes. Approved in 1978, Proposition 13 limits the increase in property tax assessments at the local level to a 2% increase each year, effectively limiting local property tax revenues received by school districts and local governments. K-14 schools became primarily the responsibility of the state and spending levels were enshrined in Proposition 98 (1988) which mandates a minimum level of education spending. These amendments are one of the major reasons for the structural imbalance of revenues and expenditures that the state has chronically experienced. The second complicating factor is the Constitutional requirement for a 2/3 majority to approve the budget or raise new taxes. This has led to gridlock in the current budget negotiations as neither party holds a 2/3 majority. The Governor and Republican Legislative members are currently opposing any new taxes. The Democratic Legislators are opposing a budget fix based entirely on eliminating key social service programs. At some point this impasse must end and the likely outcome will probably be some combination of new taxes, expense cuts and one-time measures such as deferrals or fund transfers. However given the politically polarized environment in Sacramento, this is not likely to happen until the crisis has worsened further. We believe this could include either a partial government shut-down or the outright suspension of state programs.

Positioning the Portfolio

From an investor's standpoint, assessing the political risk is the most difficult part of the investment decision at this point. At this time, bondholders are largely compensated for the additional risk and the state's bond yields have been the equivalent of a triple-B credit for some time despite the fact that the rating agencies maintain single-A ratings. Nevertheless, markets tend to move toward extremes. As a result, spreads can at times become detached from fundamentals. This in turn creates panic in the market, driving spreads wider. As the chart below demonstrates, the state's bonds have recently been trading at historically high spreads to the municipal triple-A benchmark curve.

California 10-Year GO Yield Spread Relative to Municipal 10-Year AAA GO Benchmark

Source: Thomson Financial

However, given the continuing uncertainty, we are currently taking several defensive measures, including limiting client accounts to a moderate proportion of California state exposure. For our California accounts, we have large allocations to pre-refunded bonds and to bonds sold by essential service providers (e.g. essential-service utilities, schools and certain higher education institutions) which remain relatively stronger during this crisis. We are also focusing on those regions in the state which possess legitimate, long term growth potential and avoiding those areas which benefited disproportionately from the now defunct housing boom. Though we are taking defensive measures, we are not advocating a wholesale elimination of California state credit exposure. We believe budget resolution is inevitable and that the strong bondholder protection inherent in the priority of cash payments discussed above will ensure payment of debt service. If the crisis appears to be abating, we may at a later date consider whether to add to our California positions, particularly if spreads remain under pressure. In that environment, there may be significant value in adding California exposure even in non-California accounts.

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