Fixed Income Insight
March 6, 2003

California Municipal Bonds

During the fourth quarter, California's sluggish economy showed a loss of jobs across all industry sectors and one of the nation's highest unemployment rates. The weakness in the economy compounds the already present weakness in the state's financial position. Over time, the deterioration in state finances is likely to make credit conditions even more challenging for many local units and state agencies that receive direct or indirect support from the state government. We remain cautious about the impact of the state's negative credit momentum on California municipal bonds.

- According to the Governor's office, the state's budget shortfall is estimated to be as high as $30-35 billion covering the fiscal year period ending June 30, 2004. Gov. Davis has proposed spending cuts of around $10 billion, including reductions in all nonessential programs and activities, education funding, as well as transferring money from idle fund balances of various state programs into the general fund. In addition, various one-time revenue raisers are being considered including a proposal to use pension bonds to fund the current portion of state contributions. Despite a decline in tax revenue, overall cash flow does not appear to be sufficiently low enough to cause an immediate crisis. Short term borrowing will probably be necessary in the spring to smooth cash flow needs as well as to weather any delays in passing a budget. For this reason, the state requires continued market access to fund cash flow timing gaps.

- The Department of Water Resources issued $11.25 billion in bonds in the 4th quarter to reimburse the state for earlier power purchases and to provide for near- and longer-term energy supplies. The bond issue provided some short term cash relief to the state government and mitigated the potential impact of power price spikes, should they occur.

- The governor plans to issue over $5 billion in state related bonds to help cover capital infrastructure costs and act as a stimulus for the economy. Heavy spurts of supply may be a factor periodically affecting bond prices on all California issues. However, demand thus far for California bonds remains relatively vigorous and able to absorb new issues.

- Low mortgage rates kept existing home sales active and home values high through most of 2002; however, residential construction declined significantly in November and December. Commercial construction was weak most of the year but picked up somewhat towards the end of the year. Existing home sales were up compared to 2001. Overall, real estate was weakest in the San Francisco and Silicon Valley region and strongest in Orange County and the capital region. A prolonged slowdown in the economy would eventually have an impact on real estate and related tax development bond issues.

- State budget cuts are likely to have an adverse impact on local governmental units within the state. Counties are likely to be among the most affected, followed by schools and then cities. In the latter case, the cutback in motor vehicles license fees currently allocated to local units is likely to reduce credit quality on units that are debt burdened or otherwise dependent on these monies.

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- While municipal utility debt has held up well in regards to credit quality, looking ahead, the state appears to be more challenged to maintain adequate water supplies. The essentiality of water service still warrants quality financial support for most bond issues. Most municipal electric bonds in California have maintained solid coverage since they were only modestly impacted by the deregulation of the investor-owned utilities.

- California hospitals have continued to show a generally challenged financial environment. Resistance to premium hikes, the need for capital outlay improvements, and the nursing shortage require high selectivity in holding hospital bonds. Medi-Cal payments for welfare patients, which is funded in large part by the state, have generally been held stable. Continued financial pressures at the state government makes this source vulnerable to future budget cuts.

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