

Fixed Income Insight

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Update on California Credit Quality: Not Out of the Woods Yet

This past summer, California's bond ratings were slashed to one of the lowest ratings assigned to any state in the past fifty years. S&P downgraded the state's general obligation bonds to BBB in late July after the state approved its new budget. The change left California in the company of only two other states that have ever been rated in the BBB category by S&P. Moody's downgraded the state too, but held the rating in the lowest rung of the "A" category and kept the state's outlook in the negative direction. Fitch kept its "A" rating but had the state on negative credit watch.

The State of California's credit problems are dramatic and overflow onto many other credits in California. The state's fiscal viability directly or indirectly impacts many other credits and sectors related to bonds both with and without the state's name directly identified as the primary security on the face of the bonds. In addition to state general obligation bonds, other issues directly related to the state's credit are the bonds issued for Public Works, Public Financing Authorities (e.g. Riverside, Oakland, Sacramento, San Bernardino and San Francisco), the East Bay State Building, as well as the Los Angeles State Building Authority (i.e. Ronald Reagan office building). Recently, the Golden State Tobacco Securitization Bonds received the double-barreled support of the state's general fund as well as tobacco settlement monies.

Indirectly, a host of issuers receive support or guarantees from the state government. They include:

- California state universities and community colleges (receive subsidies from state)
- Dozens of hospitals indirectly backed by mortgage insurance programs
- Counties that are charged with social welfare responsibility, including hospitals that receive state appropriated MediCAL payments
- Public schools (protected somewhat by Proposition 98, but eventually could be affected if budget is shrunk)

Is the Worst of the California Fiscal Crisis Over?

The Current fiscal plan depends on three factors that must be successful—economy, the ability to borrow money and the state's political support:

1. The Economy

Initially, the state's fiscal problems were exacerbated in 2001 and 2002 by a relatively weak economy that couldn't offset the spending increases that bloated the budget during the previous few "high tech boom" years. In the past year, the state's economy has shown moderate growth but not by wide margins. The current plan requires modest-to-moderate economic growth statewide in order for it to work. If the economy continues to grow at a 3% (or more) pace for the next few years, it should keep the plan in place. However, it provides little cushion for any retrenchment if growth slows or if a recession develops.



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2. *The Ability to Borrow Money*

The current budget is reliant on a huge dose of short and long term deficit financing (\$18 billion out of the \$38 billion budget deficit identified). Failure to access the market to borrow sufficiently raises the possibility that the state will be required to go back to the drawing board in order to avoid a cash crunch. The biggest obstacle is the recent wave of legal challenges facing the three borrowing plans.

Just last week, the California courts rejected a planned \$2 billion bond issue that was intended to fund the state's current year pension obligation. The court said the issue was in violation of the state's constitution that requires voter approval on debt issues. This ruling may be used as a precedent for two other borrowings. The first possible precedent may come from the \$11 billion deficit bond financing planned for early next year that is now being challenged in the courts by the Pacific Legal Foundation and Fullerton Taxpayers Association. The inability to sell this issue would mean that the state may not be able to fund the repayment of \$11 billion in currently outstanding Revenue Anticipation Notes slated to be repaid in June 2004. That would necessitate either a rollover issue of new RANs (which could prompt a downgrade) or a purchase agreement could be arranged with the investment bankers that underwrote the deal.

The second possible precedent may come from the \$2 billion Tobacco Securitization bond issue sold during the third week of September. It too might be challenged as valid state debt by the American Heart Association. The good news for the state is that the market accepted the deal, providing the state with its proceeds. The bad news appears to affect the bondholders who think that they have a California annual appropriation guarantee in their pocket. The AHA sent out a last minute notice to the State just before pricing on the bonds saying that they questioned the state's ability to issue debt with a voter authorization to back the tobacco bonds. Investors should take all court challenges seriously. In 1983, amidst an unpopular project to build multiple nuclear generating plants in the Northwest, the State of Washington Supreme Court ruled that the Washington Public Power Bonds were invalidly issued and negated the security for the issue. Courts are often reflective of the popular mood.

3. *Political Support*

The third most important ingredient for making the current fiscal plan successful is the ability to garner political support to either raise revenues or cut spending. Leadership consensus is critical here. The recall slated for October 7 is symbolic of the political instability in the state. No matter who wins, the new Governor will likely have his hands full for at least the next two years. There still remains considerable division on important elements in the current budget plan including the hated vehicle license tax—which is an important revenue source used to balance the budget.

A political stalemate has characterized recent budget battles. Difficulty in reaching consensus and compromise is related in part to a governmental structural framework that makes budget balancing perennially difficult. Term limits and strong political orthodoxy in politicized districts make it harder to reach a political consensus, not to mention the fact that it takes two-thirds of the legislature to raise taxes.

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If economic growth cannot be maintained, if borrowing is restricted, or if politicians fail to reach consensus, the chances of a cash crisis at the state level increase. That would, in our opinion, be the greatest risk. To some extent, we loosely estimate that there is some slack (approximately \$3 to \$5 billion in interfund cash flow borrowing) in the state government to cover some setbacks. This ability to borrow from accounts outside of the general fund provides a modicum of additional cushion to help avert a GO default if one or more of the key factors supporting a successful fiscal plan are not realized.

Worst Case Scenario

The state is a sovereign credit and therefore it can't go bankrupt any more than Argentina, for example. It can repudiate its debt, but that is not likely given the reality of the state's huge economic base and the nightmarish impact it would have on the rest of the nation both politically and economically. The federal government would have a vested interest to help resolve the situation.

A default or moratorium can occur, albeit even a short one, as seen in New York City in 1975 or Cleveland shortly thereafter, if it runs out of cash and especially if it can't access the market for borrowing. Nevertheless, the general obligation bonds are likely to be repaid as the security legally promises to make good sooner or later. Annual appropriation debt carries a somewhat higher risk since the promise to eventually repay is not legally guaranteed if it is not included in the current budget.

Final Words

There is still plenty of work to do in order to stabilize the state's credit quality. Deficit financing is a critical source of the current fiscal plan. Access to the markets is a crucial requisite for keeping the plan alive. The markets must be able to digest a growing supply of California debt at reasonable rates. The build up of outstanding debt to pay for past deficiencies squeezes the ability to issue bonds for normal capital needs. Using up debt capacity to cover operations now will make it even harder to repeat the use of bailout debt in the years ahead. While default still appears to be unlikely, it is not impossible to envision such a worst case scenario. Moderate economic growth and state political stabilization will go a long way to help reduce the chances for an exacerbated credit crisis.

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