Fixed Income Insight
May 18, 2002

Cautious on California – Tough Summer for Bond Credit Quality

At the State Government Level:

Credit quality remains a big issue for California and will continue to be a factor for some time. The **State's** finances are staggering from the steep drop in tax revenues related to the downturn in the economy, the evaporation of huge stock market options and capital gains taxes, and the drawdown of its cash reserves to purchase energy. While cash shortages have been managed this year by borrowing for the general fund from other funds, we believe the state is about to exhaust its borrowable internal resources, forcing it to resort to the short term note market. The Comptroller of the state released a late April announcement that said that the state will have to issue $7.5 billion in revenue anticipation warrants in order to get through the summer months. Short term borrowing may have been avoided if the state had issued the **Department of Water Resources** $11.1 billion bond issue that was planned to be sold by now. That issue, which will reimburse the state for its energy purchases amounting to $6.4 billion, intended to be issued last year and rescheduled for August of this year, is probably going to be delayed again. While the Public Utility Commission and the involved investor-owned utilities have recently come to agreement on important elements of that financing, a recent court opinion indicated that a public hearing regarding the proposed rate increases must be conducted. Barring any new delay developments, that could push the sale from August to the Fall. When the Water Resources bond issue does get sold, the surge in California bond supply might negatively further impact the California market while the paper is being digested.

Even when eventually completed, issuance of the big Department of Water Resources deal will not immediately prop the state's credit up to a "golden state status." The state budget grew well beyond the inflation rate in recent years in line with the windfall of tax receipts. However, March 2002 tax receipts were still 73% below a year ago. Consequently, we believe cutbacks to departments, agencies and local governments will have a lingering spillover to other state credits for a period of time. Budget wrangling over cutbacks are currently taking place and a signed budget is expected by August. In our view, the state's weakened credit quality and increased supply have, to some extent, been factored into recent bond prices. Spreads are comparable to levels seen the last time the state was rated "A" in the early 1990s.

While some economic signs have emerged that the state's economy is recovering, the pace of improvement is slow and not definite. Job growth in the state has recently been mildly positive and as has building construction. Unemployment improved in February to 6.1% off of a peak of 6.4% in January. New factory orders for defense companies should be helpful to Southern California, which has a fair share of defense contractors and military installations.

Meanwhile, the state's budget gap continues to grow. On May 15, the Governor's budget plan was released which is structured to erase a near $24 billion deficit. The plan calls for over $7 billion in cutbacks, with the heaviest reductions slated for health care, social services, primary and secondary education, and general government. At the same time, new revenues will be needed from increases in cigarette taxes, motor vehicle permits, deferrals, and tobacco settlement securitization bonds. The deficit reduction plan faces political and economic obstacles which make this budget resolution less than certain.

Guiding Portfolio Strategies
McDONNELL INVESTMENT MANAGEMENT, LLC

1515 West 22nd Street • 11th Floor • Oak Brook, IL • 60523 • 630.684.8600

By late summer, insufficient progress in closing the gap could result in another rating downgrade by at least one of the rating agencies. We still consider the state's short term credit trend to be negative at the -1 momentum confidence level. The weeks and months ahead will likely result in a momentum adjustment upward or downward depending on how well the legislature deals with the issue, the completion of the Department of Water bond sale, as well as whether the state economy follows an upward economic path or not.

Local and Other Credits:

Although budget deficit projections are emerging in governmental bodies like **the Los Angeles School District**, most local government California credit problems are nowhere as financially stressed as the those of the state. Still, expected cuts to counties and eventually to schools will be felt as time goes on. While **public power** credits in the state look relatively prosperous versus California **investor-owned utilities**, margins and coverage are not as positive as for the rest of the nation. **Hospitals** in the state show positive financial strength but are relatively weaker than the nation as a whole. **Airports** in California are generally comparable when it comes to credit quality versus national statistics. **Housing, land and development** activity are still showing vitality, helping most special assessment and **Mello-Roos** bonds. Vulnerabilities appear to be more apparent in local areas associated more strongly with technology companies. **Surface transportation and toll way** bond issues have not shown any notable differences with national trends. The ailing **San Joaquin Toll Road** is hoping to merge with its healthier sister toll road, **Foothills-Eastern.** That merger faces financing obstacles that make it far from a fait accompli.

Richard A. Ciccarone
Managing Director & Chief Research Officer,
McDonnell Investment Management, LLC

This commentary is prepared by McDonnell Investment Management, LLC ("MIM") for informational purposes only. The information contained herein is neither investment advice nor a legal opinion. The views expressed by Mr. Ciccarone are as of the date of publication of this piece, and are subject to change without notice. MIM cannot assure that the type of investments discussed herein will outperform any other investment strategy in the future, nor can it guarantee that such investments will present the best or an attractive risk-adjusted investment in the future. There are no assurances that any predicted results will actually occur. Past performance is no guarantee of future results.