California Dreamin': A Reality Check - June 16, 2010

Some of the most enduring values found in municipal bonds over the past 20 years included buying state general obligation bonds during times of credit and price weakness. In the past, states such as California and Massachusetts were downgraded to a minimum investment grade, only to see subsequent credit ratings rebound considerably, with investors enjoying relatively high yields and price appreciation.

This is no longer the case. The fiscal problems confronting California are, with the possible exception of Illinois, relatively unique among all the states despite shared concerns. California's specific concerns are both immediate and long term. Investors are well served to take note of the immediate issues that could further erode the state's credit, with negative implications for market access.

The constitutional deadline for passage of the CA fiscal year 2011 budget (commencing July 1, 2010) is June 15th. While the state has a poor record of timely budget adoption over the past two decades, the implications of a late budget agreement this year could be significant, as the state's cash position could soon become severally strained.

The state is confronting an approximate $19 billion budget shortfall for FY 2011, with agreement hampered by political constraints and limited flexibility. However, the immediate issue is the state's cash position. Without a budget agreement, the state is precluded from issuing short term notes necessary for cash flow purposes.

The state's budget and cash flow projections incorporate the receipt of $10 billion in August of anticipated short-term note proceeds. This cash is needed to fund required transfers and appropriations for education. If the state has to make this payment without the benefit of the note borrowing, then the state's cash position and margin could be severely strained. In fact, such an event might force state officials to return to aggressive cash protection measures, such as the policy of issuing vouchers in lieu of cash payments. Such actions might be taken in order to ensure payment from limited resources to first priority obligations given by the state constitution to education, followed by debt service, and could occur as soon as late August.

Under this scenario, the longer the state goes without adopting a budget over the course of the summer, the higher the probability of additional credit downgrades coupled with erosion of market support.

This immediate concern, in conjunction with the State's longstanding structural credit issues, precludes us from viewing the State as a relative value opportunity at this juncture.

Sincerely,

Robert S. Waas
Managing Member

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