



Implications of the California Stalemate

As the stalemate persists over the Golden State's budget, the credit rating agencies remain on high alert. In fact, if a budget resolution is not soon forthcoming than a downgrade to BBB (2003 credit rating levels) may be a foregone conclusion. Lenders are also nervous as they follow the crisis closely and assess the safety of their holdings. The combination of weak revenues and out-of-control spending has created a sizeable hole in the states' budget. For well over a year this imbalance has persisted and was a key contributor to RSW's decision to avoid an investment in California General Obligation bonds. With that said, our election to shun the bonds was not driven by our fear of default, but of credit rating downgrades and headline risk.

To us at RSW, it seems like the problem has less to do with debt solvency and more to do with liquidity. Specifically, the state cannot borrow monies from the capital markets until a balanced budget is put forth. Unless a budget is adopted quickly the state will run out of cash. For this reason, contingency plans have been set forth which call for a number of state employees and outside vendors to receive IOU's instead of cash. This is not new for California as they last issued the IOUs in 1992 when lawmakers and then-Governor Pete Wilson deadlocked on a budget for 61 days past the start of the fiscal year.

We are now at an inflection point where the rubber meets the road. The state has been warned about the possibility of further credit rating downgrades as a fierce budget battle between Democrats and Republicans rages. Both sides have their heels dug in as they debate escalated tax hikes versus more meaningful cuts in Government expenditures.

While the tax-exempt market seems to have already priced in a state that is out of cash with CA G.O. credit spreads (the basis point differential between CA G.O.'s and generic "AAA-rated" bonds) at multi-year wides, an opportunity could be developing to begin to be a cautious buyer of the credit in relative value terms. While we are not yet willing to commit to an investment today, the risk-to-reward does seem to be turning. We continue to believe that investors confuse a liquidity problem with a solvency problem. Sure, many distressed borrowers would like to pursue the option of default to release debt pressure however, we must be mindful that a municipality must not only prove an unwillingness to pay but an inability to pay their debts. Furthermore, California constitutional law stipulates that holders of California general obligation bonds are first in line for payment, second only to education.

Sincerely,

Robert S. Waas
Managing Member

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