Municipal Market Comments

Ascent Investment Partners

February 6, 2012

from Montage Investments

Credit Perspectives on the State of Illinois

State of Illinois

G.O. Ratings:	A2/A+/A
Rating Outlooks:	Stable/Negative/Stable

Illinois was downgraded by Moody's on Jan. 6, 2012 to A2 from A1. Moody's also revised its outlook to Stable from Negative.

The State of Illinois continues to grapple with significant budget pressures that have eroded the state's financial position and credit ratings over the past several years. Like all states, Illinois experienced significant revenue declines from 2008 to 2010 as a result of the financial crisis and national recession. Unlike most other states, however, Illinois has not been able to manage its budget in a way that established more structurally sound budget performance. Consequently, Illinois' G.O. credit quality has declined substantially over the past three years. As recently as March 2009, the state was rated Aa3/AA/AA. Now, Illinois is the lowest-rated state by Moody's and tops only California in its S&P and Fitch ratings (see table below).

Despite its declining credit quality, we do not believe that there is any realistic potential that Illinois will fail to make timely payment on its general obligation debt. While we do expect that S&P is likely to downgrade the state in 2012, we believe that Illinois will maintain single-A category ratings over the long-term and we continue to maintain positions in Illinois G.O.s.

Lowest Rated U.S. States, February 2012

State	Current Ratings[1]	Rating Outlooks[1]
California	A1/A-/A-	Stable/Stable/Stable
Illinois	A2/A+/A	Stable/Negative/Stable
Arizona[2]	Aa3/AA-/nr	Negative/Negative/na
Kentucky[2]	Aa2/AA-/AA-	Negative/Stable/Negative
New Jersey	Aa3/AA-/AA-	Stable/Stable/Stable
Michigan	Aa2/AA-/AA-	Stable/Stable/Positive

[1]Current ratings and outlooks from Moody's, S&P, and Fitch, respectively.

[2]No GO debt outstanding. Listed ratings and outlooks reflect the highest issuer credit rating or state supported appropriation debt rating.

Sources: Moody's, S&P, Fitch

Illinois faces a number of very big financial problems that continue to drag down the state's credit quality. Most significant among these are:

- Persistent budget deficits since 2009.
- A substantial accumulated general fund deficit that totaled $9.2 billion at fiscal year-end (FYE) 2010, equal to almost 25% of total state general fund spending.
- A practice of delaying vendor payments and state disbursements to manage deficits. Illinois' unpaid bills were estimated to total $8.5 billion as of Dec. 31, 2011, much of which represents unpaid Medicaid program payables.
- A very large unfunded pension liability that has resulted in Illinois being the least-funded state pension system in the U.S. (43.4% funded at FYE 2011) and has substantially raised the annual costs to the state budget of funding pension-related obligations.
- High debt levels, due partly to pension funding bonds issued in the past and to the state's ongoing capital program.

It is also important for investors to realize that, contrary to popular media and business press hyperbole, states cannot go bankrupt. There are no provisions in federal law allowing states to seek bankruptcy protection – Chapter 9 bankruptcy specifically applies to political subdivisions within states. Furthermore, the Illinois Constitution requires that the Governor present, and the Legislature enact, a balanced budget. While this requirement is not without its loopholes – clearly, Illinois has carried budget deficits forward over the past few years using a variety of accounting methods – this will ultimately force the state to take steps to address an increasingly unsustainable situation. Unlike corporations and even some municipalities, there is no way out for the state other than ultimately to make the hard political decisions necessary to regain structural integrity.

Illinois is clearly in a difficult financial position. However, we do not see any real likelihood of the state being downgraded into the triple-B range, much less failing to pay scheduled debt service on state bonds. The most significant fundamental features underpinning the states bonds are:

1. Illinois has the sovereign powers inherent in states to raise revenues;
2. Illinois has no statutory or constitutional limitations on its ability to raise taxes or otherwise generate additional revenues for the state; and
3. State statute requires that debt service on state G.O. bonds is paid prior to any other state expenditures.

In addition to these structural strengths, Illinois benefits from a large and diverse economic base that is anchored by the City of Chicago. The state's employment base, though pressured by unemployment levels that are roughly 1% above the national average, has experienced improvement over the past 12 months. While the Governor and Legislature have failed thus far to make the structural changes needed to balance the state's budget, there have been positive steps over the past year. Illinois raised its income tax in 2011. While the increase is scheduled to be phased out in steps, beginning in 2015, for FY2012 it is expected to generate an additional $6 billion in state revenues. Illinois has put in place internal cash flow management structures that ensure the state will have adequate liquidity to make timely payments on debt as it comes due. The governor has also convened a working group to recommend changes in the state's pension funding approach that can be implemented by the state in 2012.

Fundamental to Illinois' financial and credit recovery will be changes to the state's pension plans. To date, state government has lacked the political will to make meaningful long-term changes. These changes will be incredibly difficult to make politically, but as we are seeing with proposals in California, Rhode Island and other states, momentum for pension funding change is building among states. In all likelihood, the state will have to reach a crisis point before there will be enough public support to force change. We do expect, though, that changes will be implemented over time that will stabilize the state's financial operations and credit quality.

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