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California and Illinois: The Lowest-Rated States Heading in Very Different Directions

State of California	Ratings	Outlooks
General Obligation bonds	A1 / A / A-	stable / stable / stable
Appropriation bonds	A2 / A- / BBB+	stable / stable / stable

State of Illinois	Ratings	Outlooks
General Obligation bonds	A2 / A- / A	negative / negative / RW-Negative
Appropriation bonds	A3 / BBB+ / A-	negative / negative / RW-Negative
Moral Obligation bonds	Baa1 / BBB-	negative / negative

Sources: FitchRatings; Moody's; S&P

The past three weeks have highlighted the divergent credit trends of the two lowest rated states, Illinois and California. On January 25, S&P downgraded Illinois to 'A-' from 'A' and maintained its rating outlook at negative. That agency followed on January 31 with an upgrade of California, to 'A' from 'A-', and assigned a stable outlook to that state's rating. Contrasting the factors behind California's improvement and Illinois' decline provides a valuable lesson in the importance of political will in shaping financial and credit strength. It also provides clues about the steps Illinois may ultimately be forced to take to stabilize its financial position and long-term credit strength.

We continue to view both Illinois and California as issuers whose general obligation bonds are suitable as core holdings in conservative portfolios, and we continue to position issues from both states in client portfolios. Despite the most recent downgrade, we continue to view Illinois' financial problems as fixable. We noted in our Sept. 4, 2012 credit review of Illinois that:

- We do not believe that there is any potential that Illinois would fail to pay its G.O. bonds;
- It is possible that the rating agencies could further downgrade the State in the intermediate term (2013-2015), but we believe that Illinois will maintain single-A category ratings over the long-term; and
- Appropriation bonds and moral obligation bonds secured by the state present higher credit risk and are not suitable for conservative investors.

Despite its mid-range rating, California also provides strong security features for its general obligation bonds. California's Constitution requires that that state G.O. bonds get paid second only to required funding of K-12 local school aid and state higher education payments. California has also proven over many economic cycles that no matter how dire the budget situation the state will do what is needed to pay its bonds.

On the surface, both Illinois and California share many credit characteristics. Both states were rated in the double-A category heading into the recession. Both states experienced substantial drops in revenues from 2008 through 2011, creating massive budget shortfalls that they struggled to close. Both states faced significant long-term pension funding pressures. Both states passed tax increases to shore up their structural budget problems and re-establish a solid revenue foundation. Why then are the states heading in opposite ratings directions?

California has a long history of "boom-and-bust" budget cycles. California's revenue base is more sensitive than most states to the performance of the economy generally and has a unique sensitivity to the performance of equity markets. When the state and national economies are strong and stock markets perform well, California has often experienced very rapid revenue growth that has generated budget surpluses and supported strong double-A credit ratings. However, when the state or national economy enters recession, California's revenues also fall very quickly, creating massive budget gaps and driving state credit ratings down into the single-A range. Although the current cycle has had a deeper trough than the state has historically faced, it mirrors past state budget cycles. While California has given investors a wild ride over the years, the state has a proven track record of muddling through its budget crises and making the fixes necessary to stabilize the state until the next wave of economic expansion boosts revenues again.

Notably, California also has a track record of having responsibly funded its pension obligations. California's pension funds have historically been fully funded (the present value of invested assets equaled the present value of future estimated liabilities), and though the valuations suffered with the steep drop in equity prices during the recession, funding levels remain above the average for U.S. states. The state and its local governments did dramatically expand their long-term pension liabilities throughout the 1990s and 2000s, creating rapidly rising demands on local and state budgets that have caused extreme financial hardship for a few California cities and looming budget pressures for many more. On the state level, though, California passed a pension funding reform bill in September 2012 that helped alleviate some of the expected future pressure on the state.

Illinois, in contrast, has historically been a much more stable economy without the dramatic fluctuations apparent in California. The state's current financial problems did not arise during the recession, but have been growing over time. Illinois has a long history of failing to balance its budget. Rather than make hard choices on expenditure cuts or tax increases though, the state pushed obligations into future budget years or failed to make timely payment to a variety of creditors. The recession dramatically reduced state revenues in

Illinois, like all states, but state legislators have been largely unable to respond effectively. The state did pass a significant income tax increase in 2011 that has boosted revenues substantially. However, slow economic growth and a failure to align expenditures with revenues has left the state with significant annual increases in liabilities.

One of the most pressing issues in Illinois is that of pension funding. Unlike California, Illinois has historically underfunded its pension plans, balancing annual budgets in part by failing to make the necessary deposits in its pension funds to keep pace with growing liabilities. As a result, Illinois has the lowest pension funding level of any state, and annual pension costs are a large and growing part of the budget gaps. Illinois did implement some limited pension changes in 2010 that are expected to lower future pension funding costs over the long term. However these changes address only future employees and are expected to actually increase budget pension costs in the near term. The Governor proposed a number of more sweeping changes to pension funding for current employees, but no changes have been passed. To date, Illinois legislators have been unwilling to make the hard choices necessary to really reform the state's pension situation. Rather, Illinois has relied on a series of pension bond issues to fund its pensions, but these efforts have only raised state debt levels and provided very short-term budget relief.

Illinois has a solid foundation supporting its credit quality. The state has a broad and deep economy, anchored by the Chicago metro area. The state's economy is growing, though slower than in some states and at rates below what state budget planners had projected. If Illinois can reform its pension funding practices to establish a more stable long-term structure, it would introduce a great deal of stability to its financial position and credit rating outlook.



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