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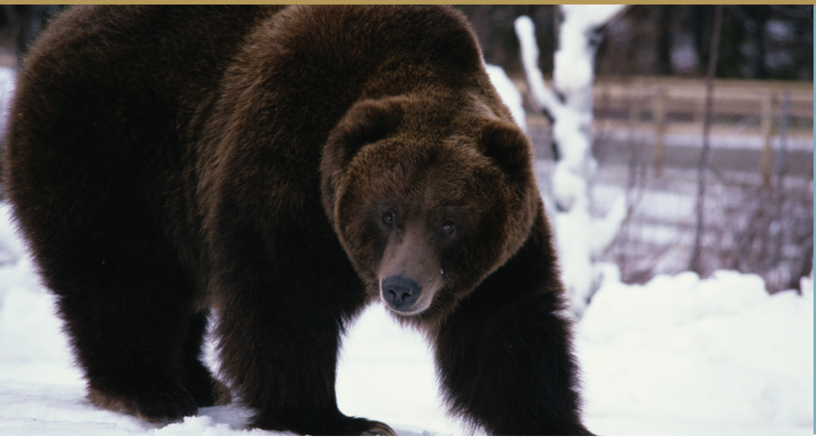
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



In One Hell of a State (2)

In our Winter Warning of December 1, 2008 entitled as above, we concluded: "From the smallest to the greatest in size, many American states are seeking direct and immediate financial assistance of an historic magnitude, from the Federal Government."

"It remains to be seen if President Elect Obama will include financial aid to state and local governments in his anticipated $500 billion (U.S.) stimulus package for the economy, because lots of states are in dire straits." In the intervening 20-month period, while financial assistance from Washington has been sparse, the deficit plight of a majority of the U.S. states has materially worsened. Indeed, states and municipalities which raise money in the $2.8 billion (U.S.) municipal bond market, have grabbed the global spotlight recently after several years of deteriorating budget deficits, igniting investor worries concerning global public finances.

The State of Illinois

Illinois is struggling under a $5 billion (U.S.) debt load and its pensions system is only funded at about 50%, the lowest of all 50 states. Illinois' inability to solve these fiscal problems within its most recent budget, have prompted credit rating downgrades; as well as take the cost to insure its debt against default to the highest level for any state. The legislature passed a partial budget in June extending the time that the state has to pay its bills from September to December; before transferring responsibility to balance the budget to Illinois Governor Pat Quinn, who has promptly initiated $1.4 (U.S.) billion in spending cuts and mapped out plans to borrow up to $4 billion (U.S.) to enable the payment of the state's pension fund contribution.

By mid-July, Illinois was ready to launch a $900 million (U.S.) bond issue, including a $500 million (U.S.) 25-year tranche, under the Build America Bonds (Babs) program, which qualifies the state for a Federal Government subsidy, since the proceeds will be used for infrastructure projects. Moreover, since its state constitution requires it to make bond interest payments before any other commitments, including education, public safety and entitlements; it enabled lead underwriter Citigroup to aggressively, market the bonds to European and Asian investors, as well as in the U.S. Accordingly, Illinois was able to sell the 25-year tranche at a 325 basis point yield spread over comparable U.S. Treasurys at an average an overall funding cost of 6.95% for the issue. John Shinsheimer, Illinois' manager of capital markets reflected: "The farther we travelled away from all the noise that is in the U.S. market on Illinois, the more focused investors were on the strength of the state's economy and the statutory support we give our bonds."

Scott Minerd, chief investment officer at Guggenheim Partners, a U.S. investment manager who purchased the Illinois bonds, commented: "The whole muni sector hangs under this sovereign (debt) cloud from Europe. If you look at how secure you are in the Illinois deal (with the priority of interest payments), you can pick up some bonds that are relatively cheap, basically, because no one wants to own them right now. The time to buy securities like Illinois is when you are being paid to take the risk."

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The State of California

The California Legislature has passed the state's budget by the July 1st. start of the fiscal year, only 10 times in the past 34 years. This year, California's Republican Governor, Arnold Schwarzenegger, and its Democrat-led Legislature are at an impasse over a huge $19.1 billion (U.S.) budget deficit, resultant from steep declines in tax revenues on property, capital gains and share options. Accordingly, Governor Schwarzenegger has ordered that 200,000 public workers be given a sweeping pay cut that would align their salaries with the U.S. minimum wage of $7.25 (U.S.) per hour. However, the Governor's administration is now going to court to enforce the order after John Chiang, the state controller, refused to implement it calling it a violation of payroll laws: "Withholding pay from state employees until a budget is enacted does nothing to solve the budget deficit, but it will only make it worse. The controller will pursue any legal avenue needed to protect Californians from the Governor's reckless executive order."

In the meantime, some California banks and credit unions are offering assistance to government employees, who may see their paychecks reduced to the minimum wage; in the form of no-interest loans, otherwise known as "budget-impasse loans." In a July 2 statement issued by Sacramento-based Golden 1 Credit Union, a lender that caters to state workers (from legislative aides to gubernatorial appointees), will offer zero-interest loans to customers whose pay falls because of the stalled state spending plan. Also, in a July 2 statement, Mr. Chiang declared: "Reducing workers' wages can't be done until the state overhauls its payroll system. I will move quickly to ask the courts to definitively, resolve the issue of whether our current payroll system is capable of complying with the minimum wage order."

The States' Budget Outlook

According to an analysis of Census Bureau data released last week by the Nelson A. Rockefeller Institute of Government at State University of New York, U.S. state tax revenues increased by 2.5% to $164.5 billion in the first quarter. The Institute report compiled data from 42 states which have released tax revenues for April and May and indicated that second quarter revenues were growing by less than 1%. Lucy Dadayan, senior policy analyst at the Rockefeller Institute commented: "Fiscal conditions remain fragile, indicating a long and bumpy road for (economic) recovery." With tax revenues still lagging and the phasing out of state assistance that was part of the $787 billion (U.S.) federal economic stimulus plan, state budgets are expected to be under strain for several years. A recent report from the National Governors Association showed states still faced $127 billion (U.S.) in budget gaps over the next two years. However, estimates do vary: this week, the U.S. Center on Budget and Policy Priorities projected the states' cumulative budget shortfall will probably reach $140 billion (U.S.) in the coming year.

The Rising Risk of Municipal Credits

According to the July newsletter of Miami Lakes, Florida based-Distressed Debt Securities, 35 municipal bond issues in the U.S. totaling $1.5 billion (U.S.) defaulted in the first six months of 2010. Last year, 194 municipal borrowers defaulted on $6.9 billion (U.S.) of bonds, compared with 162 issues totaling $8.2 billion (U.S.) in 2008. Many American municipalities are struggling to service infrastructure-related bond issues, particularly in California, Nevada, Arizona, Illinois, New York and Michigan, due to lower state revenues and construction cost over runs.

Accordingly, fixed-income investors are concerned that the risk of default for U.S. local governments is growing, amid signs that some regions are facing the same type of difficulty in reducing budget deficits as some eurozone countries. In tandem, yield spreads between municipal issuers and U.S Treasurys has widened significantly in recent months, due to investor fears that cash-strapped local governments will struggle to repay these loans. Any further yield spread widening in the municipal market will increase borrowing costs for local governments, putting more pressure on municipal finances.

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Since varying state laws do permit municipalities to default and file for bankruptcy, there is also investor concern whether or not any local governments would receive any financial support from the U.S. federal government; itself $13.3 trillion (U.S.) in debt. While states have recently seen modest tax revenue growth, local government revenues have just started to fall. Census figures show that property tax revenues – the lion's share of them collected by local governments, such as cities and school boards – declined by 0.6% to $107.7 billion (U.S.) in the first quarter of 2010 from the same period a year ago.

After years of reducing staff and cutting back on services, cities and towns across America are now outsourcing some of the most basic functions of local government, from policing to garbage collection. Services that cities can no longer afford to provide are being contracted to private vendors, counties or even neighbouring towns. Cities declare that they have little choice because outsourcing saves them the budget costs of employee health care and retirement pensions. In California, the State's $19 billion (U.S.) billion budget deficit is placing additional financial pressure on local governments. The State has begun to reduce the amount of redevelopment funds that cities have traditionally received, as Pasedena was forced to return $10.8 million (U.S.) back to the State. In Long Beach, city officials are considering a plan to help reduce an $18.5 million (U.S.) budget deficit by hiring a private contractor to manage the city's marinas. According to a report from the National League of Cities, municipalities across America will encounter a collective budget shortfall of $56 billion (U.S.) to $86 billion (U.S.) between 2010 and 2012.

The State Pension Dilemma

While state employees generally earn less than they would receive in comparable private sector positions, they have continued to receive guaranteed retirement income, while corporations are curtailing their defined pension benefit plans. However, with state pension plans continuing to be grossly underfunded, changes to pension entitlements could be in the offing. Illinois, for example, recently raised the retirement age for its employees to 67 and implemented a limit on the amount of a worker's salary that can be used to calculate pension benefits. The State is claiming savings of $300 million (U.S.) in the first year alone, but the legislation only applies to new employees. However, as recently disclosed in a New York Times article: "Despite its pension reform, Illinois is still in deep trouble. That vaunted $300 million (U.S.) in immediate savings? The state produced it by giving itself credit now for the much smaller checks it will send retirees many years in the future. By recognizing those far-off savings right away, Illinois is letting itself put less money into its pension fund now, starting with $300 million (U.S.) this year. That saves the state money, but it also weakens the pension fund, actually a family of funds, raising the risk of a collapse long before the real savings start to materialize."

In New York State, another public pension plan idea is unfolding as a disaster in the making. In order to defer its contribution to the State's pension fund which it cannot currently afford, the State will borrow several billion dollars from that very same pension fund in order to reduce contributions for the next three years. The State would repay what it borrowed, with interest, in 2013. However, New York Governor Paterson and other state officials are gambling that the stock market will have rebounded to such an extent that by 2013, that the state's overall pension burden will have been reduced. At Long Wave Analytics, we believe that this gamble doesn't stand a hope in hell of producing a positive outcome.

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