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## Many Levels of Fiscal Stress

The financial markets have seen a spike in volatility this year as investors remain focused on the fiscal problems in Greece and other weak European economies. The markets have been whipsawed by rumors/denials of a proposed European Zone bailout of Greece. While a bailout could set a bad precedent, much like the global financial system's "too big to fail" doctrine, allowing Greece to default could eventually lead to the collapse of the other PIIGS (Portugal, Ireland, Italy, and Spain). Our recent *Weekly View -- Raising the Risk Level to "Elevated"* (2/22/10), highlights the potential for sovereign risk concerns to escalate and the steps that we have taken to reduce risk in our managed portfolios.

In addition to the global sovereign credit problems, US state and local governments are also facing their worst fiscal pressures since the Great Depression. These stresses are likely to continue for at least the next couple of years, in our view, even as the national economy improves, and will likely continue to be a drag on economic growth and employment. Similar to sovereign issuers, the basic problem is that revenues (income/sales/property taxes) have fallen much more than spending, as unemployment jumped due to the severe recession. According to the January 2010 Rockefeller Institute of Government's Revenue Report, state tax collections (through 9/30/09) have declined for four consecutive quarters, beginning in the fourth quarter of 2008. The first three quarters of 2009 showed year-over-year declines of 10.9%, 16.4%, and 11.6%, respectively; the largest reductions on record. At the same time, spending decreases have been dampened by increases in social spending. The Fall 2009 *Fiscal Survey of States*, published by The National Association of State Budget Officers (NASBO), showed a 3.4% decline in general fund spending for fiscal 2009 and a 5.4% decline in fiscal 2010 based upon enacted budgets. The only other annual decline in state spending in the history of this fiscal survey came in 1983, and it was only 0.7%. The severe, negative budgetary impact on states' budgets was cushioned somewhat by the federal government's \$787 billion stimulus program, the American Recovery and Reinvestment Act (ARRA). It is estimated that about \$250 billion of the ARRA funds went to the states through various programs, but this benefit will largely run off by year end.

The states' strained fiscal condition was highlighted in a 1/11/10 report by the National Governors Association (NGA), *The State Fiscal Situation: The Lost Decade*.

*The fiscal condition of states deteriorated dramatically over the last two years because of the depth and length of the economic downturn, and state officials do not expect this situation to improve any time soon. Previous downturns have proven that **the worst budget years for a state are the two years after the national recession is declared over. States' recoveries from the current recession, however, may be prolonged, with most economists projecting a slow and potentially jobless national recovery.** Moreover, even when recovery begins, states will continue to struggle because they will need to replenish retiree pension and health care trust funds and finance maintenance, technology, and infrastructure investments that were deferred during the crisis. They will also need to rebuild contingency or rainy day funds and both implement and pay a portion of the Medicaid expansion under national health care reform. **The bottom line is that states will not fully recover from this recession until very late in this decade.***

As the poster child for state budget problems, California has been called the US government's Greece. California, the state rated lowest by both Moody's and Standard & Poor's, is currently struggling to plug a \$20 billion budget gap. California's credit default swaps (an indication of the market's default expectations) have been trading at levels similar to Greece's until recently (see chart below). In purely economic terms, California's importance to the US (13% of GDP) is significantly higher than that of Greece to the Euro zone (3% of economic output). California has been seeking government assistance, which the US government has resisted, as it is concerned that other states would also demand assistance. The Washington-based Center for Budget and Policy Priorities estimates that more than 40 states are headed for a combined budget shortfall of \$194 billion this year (about 28% of total state budgets) and \$180 billion in 2011. Investors and rating agencies would not look favorably on any US government assistance, which could lead to rating

downgrades and higher funding costs (Treasury yields). Permanently solving either California's or Greece's persistent budget problems will require some combination of revenue (tax) increases, spending cuts, reduced public pension/health benefits, or debt defaults, because neither can print currency to buy their own debt. These options will be painful, as witnessed by the rioting in Greece, but are necessary steps on the road to long-term fiscal discipline.

### California Versus Greece – Credit Default Swaps



Source: *Bloomberg*

### Investment Conclusions

- State finances are likely to remain very strained for at least the next few years, but we do not expect any state to permanently default on their General Obligation (GO) debt obligations. In fact, no state has defaulted on their debt since the great depression (Arkansas). However, there is a slight chance that we could see a temporary disruption in some bond payments due to political gridlock and posturing. In addition, there will likely be a lot of negative news flow around the most troubled states, which could cause their bond prices to remain volatile.
- Local government finances, which can rely to varying degrees upon state funding, are also likely to remain very strained, and we could see an increase in defaults by these smaller municipalities.
- The credit profile of essential service revenue bond issuers should hold up relatively well, in our view, due to their more stable revenue streams.
- We think the sectors with the highest credit risk remain concentrated in the public health care, housing, and industrial development bond sectors.

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