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California Debt Tempts Bargain Hunters By STAN ROSENBERG

While individual investors are nervous, professional portfolio managers are almost united in the view that California unquestionably will pay its debts, and the Golden State's bonds not only are a buy, but also may be an even better bargain if the headlines get worse.

Those headlines center on the state's inability to close a \$26 billion-plus budget deficit in a \$92 billion general-fund budget, a slumping economy with an 11.5% unemployment rate, ratings downgrades and warnings of more to come, and the latest ignominy of having to issue scrip, or promise of later payment, to vendors to avoid running out of cash.

On Monday, Fitch Ratings cut the state's long-term general-obligation bond ranking two notches to triple-B. Fitch kept the ratings on watch for further downgrades. Moody's Investors Service and Standard & Poor's Ratings Services also have issued ratings warnings.

California bonds already were trading at levels in line with triple-B-rated municipal debt. The fear in the market now is, if the bonds are reduced to junk, many institutions no longer would be able to hold them under their investment guidelines, producing what Miller Tabak Asset Management Chief Executive Michael Pietronico last week described as a "cataclysmic event."

Individual investors have been scared by the flow of bad news. "Customers are extremely edgy," said Gary Pollack, head of fixed-income trading and research at Deutsche Bank Private Wealth Management.


Mr. Pollack hasn't bought California general-obligation bonds -- those payable from a pledge of the state's taxing power -- in a while, "but I'm thinking of it [now] because I still think the state will make principal and interest payments."

And there is a chance to pick up yield on bonds in which professionals have almost unwavering faith. On Tuesday, a California 4.5% tax-exempt bond maturing in 2036 traded at a 6.31% tax-free yield to maturity. That equals a 9.48% taxable equivalent yield for an investor in the 35% tax bracket, more than double the yield of the 30-year taxable Treasury bond, Mr. Pietronico said.

"I'm hearing a lot of people who are very concerned," said Peter Coffin, president of Breckinridge Capital Advisors.

The state has the obligation and ability to meet principal payments on its bonds. And Mr. Coffin maintains the state's willingness isn't in doubt "because California, like most municipalities, recognizes that failure to meet its obligations in a timely manner would for a generation prove extremely costly." The state would be unable to borrow, even though it already has plenty of borrowing authorized.

"The headlines are scary, but we just put them in perspective," Mr. Coffin said, pointing out the state has a "very manageable" level of debt service around \$5.2 billion, just 5.6% of the proposed budget.



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A large level of expenditures would be cut before California would miss a debt payment, and the state's resources make this "unlikely from a fundamental perspective," according to a Samson Capital Advisors report.

The state constitution gives general-obligation debt service the second-highest priority, behind public-school funding. Based on the most recent estimates for fiscal 2010, which started July 1, public-school payments equal \$38.8 billion, which leaves \$53.5 billion to cover \$4.5 billion of debt service, according to Samson analysts Judy Wesalo Temel and Stephen A. Stowe.

Still, Samson is taking defensive measures, including limiting client accounts to a moderate proportion of California exposure, but the analysts stressed they aren't advocating wholesale elimination.

"We believe budget resolution is inevitable and that the strong bondholder protection inherent in the priority of cash payments ... will ensure payment of debt service," they wrote.

Longer Treasurys Rise, With 10-Year at 3.460%

Treasurys maturing in three years or more rose Tuesday as weak stocks, a stronger dollar and lower crude-oil prices fueled a flight-to-safety bid.

Treasury-market participants also were encouraged by a decent three-year note auction that reaffirmed foreign investors' continued appetite for U.S. government debt.

The benchmark 10-year note was up 12/32 point, or \$3.75 per \$1,000 face value, at 97 7/32. Its yield fell to 3.460% from 3.506% Monday, as yields move inversely to prices. The 30-year bond was up 23/32 point to yield 4.308%.

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