

State of the States / December 2009

BAD AND GETTING WORSE

Economists have indicated that the recession may have ended officially during the third quarter of 2009. However, states are still in the middle innings of a downturn that could continue through mid-2011. The fiscal condition of the states has worsened since our last report was issued in April 2009. State revenue growth historically has lagged the end of a recession by 18 months to two years.

We expect drivers of state fiscal health such as personal income, employment and housing prices to continue to worsen through the first half of 2010. An additional 10% drop in home prices has been projected. Retail sales growth is expected to be very slow. The capital gain tax revenue component of personal income tax receipts has all but vanished. The weak economy has pushed more state residents into Medicaid, for which the states bear much of the cost burden.

All states are now experiencing lower year-over-year revenue declines. Overall state tax collections in the April to June quarter of 2009, as reported by the census bureau, declined 16.6% from the same quarter last year. Double-digit revenue declines are occurring for several large states, including New York, California and Illinois. States that depend on income tax revenues are seeing the largest declines. Even the farm belt and energy states are seeing lower revenues as commodity and energy prices have fallen. In addition, “Rainy Day” fund balances largely were exhausted during FY 2009. In short, as difficult as FY 2009 was, we believe FY 2010 will be worse with significant mid-year budget gaps emerging.

Stimulus money provided directly to the states via the American Recovery and Reinvestment Act of 2009 (ARRA) has mitigated the crisis somewhat. These monies were used to close FY 2009 and FY 2010 budget gaps. ARRA provided states with a temporary increase in the share of Medicaid expenses paid by the federal government and money for education. The total amount of direct aid to the states is estimated at over \$135 billion to be distributed through 2011. Unfortunately, for the same period, this compares with an estimated state aggregate budget gap of over \$300 billion.

Recurring state tax revenues currently are not covering General Fund expenditures. Tax increases, borrowing, non-recurring revenue actions and budget cuts have been used in conjunction with stimulus money to make ends meet. With revenue growth at least 18 months away on average, we expect to see widening budget gaps and painful political choices with negative implications for credit quality. Federal stimulus money, in addition to the amount that has been approved, may be needed by next year to prevent state and local fiscal disasters.

KEY FINDINGS

- All states are now experiencing revenue declines;
- FY 2010 state revenues are declining more than expected;
- The American Recovery and Reinvestment Act of 2009 (ARRA) has assisted states in addressing current budget issues, but cannot alone solve longer term budget deficits;
- The likelihood of a state GO payment default remains remote;

- State credit quality is a lagging economic indicator - weak state fundamentals will continue into 2011 and perhaps longer;
- Current Rating Agency ratings are catching up to states' weakened credit quality;
- Conning's proprietary model to rank the states and provide outlooks is based on quantitative factors that we believe are predictive of credit quality;
- Conning maintains a negative outlook on bonds backed by State General Fund revenues.

BACKGROUND

States are the largest issuers of debt in the municipal marketplace. State GO bonds also are viewed as the lowest risk type within the municipal credit universe. Their credit strength is based upon their full faith and credit pledge, sovereign powers with substantial control over spending and revenue raising, broad economic and tax bases and the ability to access credit markets on short notice. Despite these strengths, states are also very vulnerable to changes in economic conditions due to their revenue mix. Unlike their political subdivisions which rely more on usually stable property tax revenues, on average, states depend on personal and corporate income taxes and sales taxes for almost 90% of their General Fund revenues.

STATE OF THE STATES METHODOLOGY

Our study differentiates credit quality by state. We have ranked the credit quality of State general obligation debt using ten indicators that measure what we believe are the most critical factors. We also have calculated individual state credit outlooks based on a different set of five indicators that measure change over a shorter period of time. Our unique analysis of state credit quality helps us determine relative value between states and provides us with a disciplined approach to manage state exposures for both State GO debt and other credit types.

The willingness and ability of states to take corrective budget action is a critical capability common to all states. However, in our opinion, it obscures less controllable, but real credit differences between states. Here we rank states by objectively using the credit indicators that provide a less subjective and truer indication of the economic and fiscal health of the states.

CREDIT INDICATORS

The indicators selected measure a state's business climate, economic activity, changes in housing prices, wealth, debt loads, income and economic factors, as well as traditional state financial condition credit measures. Since our first report, we have altered some of the credit indicators. This year we added direct stimulus dollars received per capita pursuant to ARRA. States with higher Medicaid caseloads benefited because they received more dollars on a per capita basis. This positively affected the rankings of certain states such as California, New Jersey and New York. We also added other post retirement liabilities (OPEB) per capita. OPEB measures future expenditures for state retirees, primarily health care. This also resulted in some ranking movement. For example, Connecticut has the highest OPEB/capita liability and its state rank fell to 30th from 18th.

The following tables set forth the indicators and the weightings assigned to arrive at overall credit and outlook rankings.

Credit Indicator	Measurement	Weighting
Laffer State Economic Competitiveness Ranking	State business climate	10%
FY 2009 General Fund Balance as a % of General Fund Revenues	Financial Condition	10%
Real State GDP Growth	Economic activity	10%
Current State Unemployment Rate	Economic activity	10%
Median Household Income	Income levels	10%
Per capita Income	Income level	10%
Foreclosures per 5,000 households	Housing Price Movement	10%
Debt per capita	Financial Condition	10%
Per capita OPEB liability	Financial Condition	10%
Direct Stimulus dollars received per capita from the ARRA	Financial Condition	10%

THE RESULTS

State	Current Rank Oct-09	Prior Rank Mar-09	Ranking Improvement or Decline
Wyoming	1	1	0
North Dakota	2	3	1
South Dakota	3	7	4
Oklahoma	4	6	2
Nebraska	5	5	0
Iowa	6	20	14
Virginia	7	9	2
Minnesota	8	16	8
Texas	9	2	-7
Colorado	10	11	1
Vermont	11	21	10
Montana	12	14	2
Alaska	13	4	-9
Maryland	14	23	9
Massachusetts	15	13	-2
New Hampshire	16	37	21
Missouri	17	32	15
Kansas	18	28	10
Washington	19	8	-11
Louisiana	20	10	-10

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State	Current Rank Oct-09	Prior Rank Mar-09	Ranking Improvement or Decline
New Mexico	21	25	4
New York	22	12	-10
Utah	23	22	-1
Delaware	24	34	10
Pennsylvania	25	15	-10
Tennessee	26	27	1
Mississippi	27	45	18
Maine	28	40	12
Indiana	29	33	4
Connecticut	30	18	-12
Arkansas	31	39	8
West Virginia	32	44	12
Hawaii	33	19	-14
Wisconsin	34	42	8
Arizona	35	24	-11
Idaho	36	17	-19
Oregon	37	31	-6
Florida	38	36	-2
Rhode Island	39	50	11
Nevada	40	29	-11
Georgia	41	30	-11
New Jersey	42	38	-4
North Carolina	43	26	-17
California	44	35	-9
Alabama	45	43	-2
Illinois	46	48	2
South Carolina	47	41	-6
Michigan	48	49	1
Ohio	49	47	-2
Kentucky	50	46	-4

MAJOR RANKING ORDER CHANGES

The following states had double-digit improvements in their state rankings.

State	Rank Oct-09	Rank Mar-09	Improvement in Rank	Reasons for Rank improvement
New Hampshire	16	37	21	Low unemployment rate, GDP growth, improved GF operations
Mississippi	27	45	18	Improved GDP growth, low foreclosures, low OPEB liability
Missouri	17	32	15	Low debt, moderate OPEB liability, low rate of foreclosures
Iowa	6	20	14	Low unemployment, low foreclosures, GDP growth
Maine	28	40	12	Improved GF operations, low foreclosures, low OPEB liability
West Virginia	32	44	12	Low foreclosure rate, strong GDP growth

State	Rank Oct-09	Rank Mar-09	Improvement in Rank	Reasons for Rank improvement
Rhode Island	39	50	11	Improved GF operations, low OPEB liability, high stimulus per capita
Vermont	11	21	10	Low unemployment, Better GF operations, lowest number of foreclosures in nation.
Kansas	18	28	10	Low OPEB liability, low foreclosures, GDP growth
Delaware	24	34	10	Low unemployment, GDP growth and low foreclosure rate

The following states experienced the greatest decline in their ranking.

State	Rank Oct-09	Rank Mar-09	Decline in Rank	Reasons for Rank Decline
Idaho	36	8	-28	Low GDP growth, very high foreclosure rate, weak GF operations
North Carolina	43	26	-17	High unemployment rate, low growth, high OPEB liability
Hawaii	33	19	-14	Slower GDP growth, high foreclosure rate, high OPEB liability
Connecticut	30	18	-12	Slower GDP growth, high OPEB liabilities, weaker GF obligations
Washington	19	8	-11	High unemployment, weak GF operations
Arizona	35	24	-11	High foreclosures, slower GDP growth
Nevada	40	29	-11	High foreclosures, slower GDP growth
Georgia	41	30	-11	High foreclosures, high unemployment rate

OUTLOOK INDICATORS

In order to determine a credit outlook for each of the 50 states, we selected five leading indicators of credit quality. The goal is to differentiate state outlooks based on a balance of recent economic, housing and credit factors.

Outlook Indicator	Measurement	Weighting
Tax Revenue Growth	Credit	20%
Population Mitigation – one year change in population	Economic	20%
Quarterly change in Housing Prices	Housing	20%
Year over Year Employment growth	Economic	20%
Year over Year Building permits	Housing	20%

STATE CREDIT OUTLOOKS

We have divided the state outlooks into five roughly equal categories based on the aggregate score in the Outlook Indicators above.

Among the Best	Improving	Stable	Declining	Among the Worst
SOUTH DAKOTA	NEBRASKA	NEW MEXICO	FLORIDA	ARIZONA
WYOMING	ARKANSAS	ALABAMA	NORTH CAROLINA	CONNECTICUT
TEXAS	WASHINGTON	LOUISIANA	MASSACHUSETTS	OHIO
OKLAHOMA	NEVADA	IDAHO	COLORADO	ILLINOIS
KANSAS	PENNSYLVANIA	RHODE ISLAND	MISSOURI	GEORGIA
IOWA	NORTH DAKOTA	CALIFORNIA	ALASKA	HAWAII
VIRGINIA	TENNESSEE	SOUTH CAROLINA	NEW HAMPSHIRE	MARYLAND
KENTUCKY	UTAH	WEST VIRGINIA	NEW JERSEY	MICHIGAN
MINNESOTA	MISSISSIPPI	DELAWARE	OREGON	WISCONSIN
VERMONT	INDIANA	MAINE		NEW YORK
		MONTANA		

THE BEST AND THE WORST STATES

Nine states are ranked in the top 10 AND have positive outlooks.

Wyoming	1	Among the best
North Dakota	2	Improving
South Dakota	3	Among the best
Oklahoma	4	Among the best
Nebraska	5	Improving
Iowa	6	Among the best
Virginia	7	Among the best
Minnesota	8	Among the best
Texas	9	Among the best

States with a low rank AND negative outlooks are:

Ohio	49	Among the Worst
Michigan	48	Among the Worst
Illinois	46	Among the Worst
North Carolina	43	Declining
New Jersey	42	Declining
Georgia	41	Among the Worst

One state to note is Kentucky – ranked 50th, while ironically having an outlook among the best. The high outlook ranking reflects recent relative growth in employment and tax revenues (albeit from a low base).

RECENT RATING AGENCY ACTIONS

Recent rating actions since our last report have been in line with our previous rankings and outlooks. In addition to our State of the States ranking, Conning assigns ratings to GO debt issued by the states. Our State of the States ranking and outlook are major factors in our assigned state ratings. Individual state ratings also reflect specific security features, unique credit factors and recent developments.

Credit	Agency	Action	Date	2009 Conning State Rank / Outlook
MICHIGAN ST GOs	Moody's	Outlook Change to Negative from Stable	3/25/2009	44 / Among the Worst
ILLINOIS ST GOs	Moody's	Downgraded to A1 from Aa3	4/3/2009	48 / Declining
FLORIDA ST GOs	Moody's	Review for downgrade (Aa1)	4/21/2009	37 / Among the worst
NEVADA ST GOs	Moody's	Downgraded to Aa2 from Aa1	5/20/2009	28 / Among the worst
OHIO ST GOs	Moody's	Downgraded to Aa2 from Aa1	6/15/2009	47 / Among the worst
CALIFORNIA ST GOs	S&P	Review for downgrade (A)	6/15/2009	35 / Among the worst
CALIFORNIA ST GOs	Moody's	Review for Downgrade (A2)	6/19/2009	35 / Among the worst
CALIFORNIA ST GOs	Moody's	Downgraded to Baa1 from A2	7/14/2009	35 / Among the worst
FLORIDA ST GOs	Moody's	Removed from WatchList (Aa1)	7/14/2009	37 / Among the worst
ILLINOIS ST GOs	Moody's	Review for Downgrade (A1)	7/16/2009	48 / Declining
NEW JERSEY ST GOs	Moody's	Outlook Change to Negative from Stable	8/3/2009	38 / Improving

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TEXAS ST GOs	S&P	Upgraded to AA+ from AA	8/11/2009	2 / Among the best
CALIFORNIA ST GOs	S&P	Removed from WatchList (A)	8/18/2009	35 / Among the worst
ILLINOIS ST GOs	S&P	Outlook Change to Negative from Stable	8/19/2009	48 / Declining
ARIZONA STATE	S&P	Outlook Change to Negative from Stable	8/19/2009	23 / Among the worst
WEST VIRGINIA ST	S&P	Upgraded to AA from AA-	8/20/2009	45 / Improving
CALIFORNIA ST GOs	Moody's	Removed from WatchList (Baa1)	8/21/2009	35 / Among the worst
WEST VIRGINIA ST	Moody's	Outlook Changed to Positive from Stable	8/21/2009	45 / Improving
PENNSYLVANIA ST GOs	Moody's	Outlook Change to Negative from Stable	8/24/2009	14 / Stable
OHIO ST GOs	Moody's	Outlook Change to Negative from Stable	8/24/2009	47 / Among the worst
OHIO ST GOs	S&P	Outlook Change to Negative from Stable	9/23/2009	47 / Among the worst
LOUISIANA ST GOs	FITCH	Upgraded to AA- from A-	10/8/2009	9 / Among the best
LOUISIANA ST GOs	Moody's	Outlook Change to Positive from Stable	10/9/2009	9 / Among the best

CONCLUSIONS

The overall credit outlook for the states remains negative with credit challenges ahead. Since April 2009, all states now are reporting year-over-year revenue declines. The federal economic stimulus package is providing meaningful direct aid to states, preventing an even greater crisis. States enacted FY 2010 budgets (FY beginning July 1) using a combination of tax increases (14 states raised taxes), one-time budget actions (such as borrowing from other state funds – most notably CA, deferring expenses, and selling assets), stimulus money and budget cuts. Early results indicate that FY 2010 revenues are running behind projections, especially for several of the larger states. As the fiscal year progresses, we expect budget gaps will reemerge, generating public discussion and more painful choices.

Over the past six months, Rating Agency actions have been mostly negative, occurring more frequently and are generally in line with our prior ratings and outlooks. Over the course of 2010, we expect even more frequent credit downgrades as Rating Agencies' actions are a lagging indicator of credit quality. Although the chance of payment defaults for state-backed credits remains very remote, troubles in this credit sector will dominate the headlines for the next 18 to 24 months. During this period, our approach for this sector is to be underweight and to be very selective when choosing the appropriate credits.

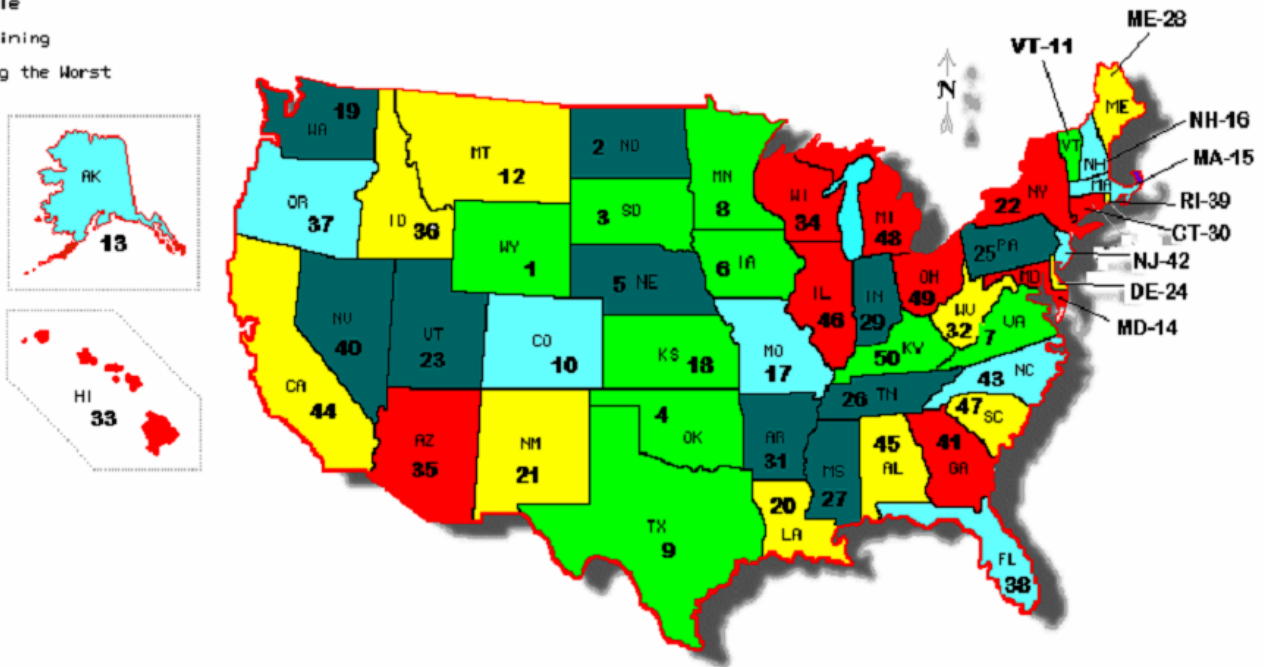
Paul Mansour
Jon Rappaport

Appendix A – STATE OF THE STATES RANKING AND OUTLOOK MAP, OCTOBER 2009

Outlook color

- - Among the Best
- - Improving
- - Stable
- - Declining
- - Among the Worst

**State of the States Ranking and Outlook Map
October 2009**



Appendix B - DESCRIPTION OF INDICATORS

RANK INDICATORS

Laffer State Competitive Environment (10% weight)

Arthur Laffer, a supply-side economist, developed the Laffer State Economic Competitive Index. His most recent analysis of the states was released in March 2009 and prepared for the American Legislative Exchange Council (ALEC). The report assigns an Economic Outlook Rank based on a state's current standing in 16 state policy variables including top marginal personal and corporate income tax rates, property and sales tax burdens, and state minimum wage.

Median Household Income (10% weight)

This indicator ranks the states according to their median household income. This information was taken from the Income, Earnings, and Poverty Data From the 2008 American Community Survey, which was issued September 2009. Median household income is the amount in dollars that divides the income distribution of each state into two equal groups. The two groups are those that are above that amount and those that are below that amount.

Real GDP Growth by State (10% weight)

This indicator ranks the states according to their percent change in GDP growth from 2007 to 2008. This information was taken from a U.S. Bureau of Economic Analysis report dated June 2, 2009. In our chart we compare each state's percent change in GDP growth to the U.S. percent change in real GDP growth.

General Fund Balance (10% weight)

This indicator ranks the states according to their General Fund balance as a percent of expenditures for their most recent FY, 2009. Each state's ending balance and budget stabilization fund are added together to equal their total funds. Each state's total fund is then divided by that state's expenditures. This data was taken from The Fiscal Survey of States, dated June 2009.

Debt per Capita (10% weight)

This represents total state related debt divided by population. It was obtained from a Moody's special report published in July 2009.

OPEB Liability Per Capita (10% weight)

This indicator ranks the States by their per capita OPEB liability. It was obtained from an S&P report titled, "U.S. States' OPEB Liabilities and Funding Strategies Vary Widely," and dated July 3, 2009.

Per Capita Income (10% weight)

This indicator ranks the states according to their third quarter 2008 per capita income statistics. This information was taken from the U.S Bureau of Economics and the U.S Census Bureau. Per capita income is the mean income computed for every individual in a particular group. This is calculated by dividing the total income of a group by the total population in that group. In our chart, each state's per capita income is compared to the U.S. per capita income.

of Foreclosures (10% weight)

This indicator ranks the states in order of the # of foreclosures per 5,000 households. The data was obtained through RealtyTrac.com and Stateline.org.

Stimulus per capita (10% weight)

This rank indicator, given a 10% weight, ranks the state according to the funds received from the American Recovery and Reinvestment Act of 2009 for Medicaid payments, fiscal stabilization and education grants divided by the states population.

Unemployment Rate (10% weight)

This indicator ranks the states by their August 2009 unemployment rate. The unemployment rate is the percentage of the labor force that is unemployed but is actively seeking employment and is willing and able to work. Our data was obtained from the Bureau of Labor Statistics.

OUTLOOK INDICATORS**Quarterly Housing Prices (20% weight)**

This indicator ranks the states according to their quarterly percent change in housing prices for the period ending December 31, 2008. These statistics were taken from an OFHEO report dated February, 2009.

Year-over-Year Employment Change (20% weight)

This indicator ranks the states by their YoY employment growth. The data was taken from the U.S Bureau of Labor Statistics, and tracks the total employment growth from August 2008 to August 2009.

Year-over-Year Population Growth (20% weight)

This outlook indicator ranks the states according to their population change from July 1, 2007 to July 1, 2008. This data was obtained from the U.S Census Bureau's Population Division.

Percent Change in State Tax Revenues (20% weight)

This indicator ranks the States in order of their percent change in tax revenues from 2Q08 to 2Q09. The data was obtained from a U.S. Census Bureau report dated September 2009.

Building Permits by State (20% weight)

This indicator ranks the States by the YTD percent change in building permits. The data was obtained from the National Association of Home Builder's Economic Department.

ADDITIONAL SOURCES

Wilshire Consulting: 2009 Wilshire Report on State Retirement Systems March 3, 2009

Moody's Investors Service: various reports

S&P Ratings Direct: various publications

Center on Budget and Policy Priorities: American Recovery and Reinvestment Act of 2009 February 13, 2009

Center for American Progress

Nelson Rockefeller Institute of Government