

KILEY PARTNERS, INC. CREDIT REPORT

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State of Michigan General Obligation Bonds

Ratings	Moody's	S&P	Fitch
	Aa3 (N)	AA- (N)	AA- (N)
Opinion	<p>Michigan is issuing \$403 million in taxable general obligation bonds and \$65 million tax-exempt general obligation bonds. Aside from obligations of the U.S. government, there is no bond with lower credit risk than a state general obligation bond. Moody's just changed the state's outlook to Negative, "based on the state's diminished economic resiliency." S&P supports their Negative Outlook by noting Michigan is "weathering a sustained downturn resulting partly from the relative importance of domestic automakers." The focus of the rating agencies on the status of the local economy is misguided. Article V, Section 18 of the Michigan Constitution requires that the State balance its budget ("Proposed expenditures from any fund shall not exceed the estimated revenue thereof.") This means that, despite whatever economic problems citizens of the state face, the state itself, as an entity, must balance its budget. <u>Michigan, as a governmental unit, does not face financial problems in the same way that a corporation might face financial problems.</u> Michigan only faces problems of political will. Corporations can't force people to buy their products, but Michigan can and must impose taxes or cut programs.</p>		

State bonds tend to decline more than local general obligation bonds in a recession, not because they are actually weaker, but because of headline risk: State budget problems make the national news, local city budgets don't. Once the State bonds have widened out, usually at the trough of the recession, they have more upside potential than local general obligation bonds, because once the economy recovers, so do the states' finances. We have reached the point in the cycle where state bonds have cheapened and represent good value. Bonds of states hardest hit by the bad economy, such as Michigan, represent the best values because (a) they have cheapened more than other bonds, and (b) they will recover.

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- Key Points**
- Default risk: inconceivable
 - Ratings risk: low
 - State general obligations are second only to Treasuries in strength
 - Economic and budget problems largely irrelevant to creditworthiness

Security The bonds are general obligations of the state. A default by a state is inconceivable. As noted above, by Constitution, the state must balance its budget. Were Michigan to somehow default on its bonds, the Governor and virtually every member of the legislature would be turned out at the next election. They know that, and they're not going to let it happen.

There has not been a default by a state on its general obligation debt since the 1870s. There were no defaults on state general obligation bonds during the 1930s. Moody's, in its March 2007 report, *The U.S. Municipal Bond Rating Scale: Mapping to the Global Rating Scale And Assigning Global Scale Ratings to Municipal Obligations*, noted that if municipal bonds were rated using the same risk criteria as corporate bonds, all state general obligation bonds rated A1 or higher would carry a triple-A rating.

Description As a legal entity, a state, Michigan enjoys broad powers to levy and collect taxes. Demographically, the trend in Michigan is negative. The population is approximately 10 million, +1.3% since 2000 versus +7.2% nationally. Manufacturing accounts for 12.3% of employment in Michigan versus 10.4% nationally, and is concentrated in autos and auto parts. Since 2001, the unemployment rate in Michigan has exceeded the national unemployment rate by an increasing margin. In 2008, the annual unemployment rate in Michigan was 8.40% versus 5.8% nationally. In January 2009, the unemployment rate in Michigan was 11.6% versus 7.6% nationally. Per capita income has trended steadily downward over the last ten years, relative to the United States as a whole. In 1997, per capita income in Michigan equaled 100% of per capita income for the United States. In 2007, per capita income in Michigan equaled 89% of per capita income for the United States. During that decade, nominal per capita income increased 35.4% in Michigan and 52.2% nationally. Home prices in Michigan, especially in the Detroit area, have fallen because of population loss and economic deterioration, not, as in certain other parts of the country because of a price bubble and speculation.

Debt The State of Michigan will have \$1.6 billion in general obligation bonds outstanding after the new issues. The State has also given its general obligation pledge to \$14 billion in local general obligation school district

debt, but the State has never been called upon to make payments on school district debt. The Building Authority has \$5.1 billion in state appropriation-backed bonds outstanding.

Finances The Michigan economy faces severe stress due to the recession, and state revenues will probably fall modestly while aggregate demands for state spending will grow modestly, driven by programs such as unemployment insurance. This is more of a political problem than a financial problem. As noted above, the Michigan Constitution require the state to balance its budget, which the legislature can accomplish through a combination of tax increases and budget cuts any time it has the political will to do so. The state has a record of balanced budgets. Taxes are revenues of the highest quality, better than the revenues of any corporation.

Michigan operates on a fiscal year that ends September 30. The General Fund's main revenue sources are the income tax and the sale tax. The sales tax rate is 6% on retail sales with exceptions for food and prescription drugs. The personal income tax rate is a flat 4.35% and is scheduled to decrease steadily to 3.90% in 2015. The business income tax is a flat 4.95%. The personal income tax accounts for approximately 50% of the General Fund's revenues. The business income tax accounts for approximately 20% of the General Fund's revenues. The sales tax accounts for approximately 15% of the General Fund's revenues.

\$MM	FY2009e	FY2008	FY2007	FY2006	FY2005
Revenue					
Personal Income Tax	4,510	5,008	4,246	4,098	4,043
Business Income Tax	1,814	2,124	1,815	1,841	1,912
Sales Tax	1,448	1,578	1,550	1,542	1,547
Other	<u>1,774</u>	<u>1,332</u>	<u>1,835</u>	<u>1,770</u>	<u>1,539</u>
Total Revenues	9,546	10,042	9,445	9,251	9,041
Expenditures	<u>9,702</u>	<u>9,842</u>	<u>9,186</u>	<u>9,248</u>	<u>8,794</u>
Surplus (Deficit)	(156)	200	259	3	247
Fund Balance	-	458	259	3	221
% Expenditures	0.0%	4.7%	2.8%	0.0%	2.5%

The estimate for current fiscal year in the above table comes from the Monthly Financial Report of the Office of the State Budget, dated March 3, 2009. The figures include "revenue adjustments" of \$549 million in

reduced revenue sharing. In other words, the State is balancing its budget by reducing the amount of money it sends to counties and other local units of government. The State has achieved four surpluses in the past four years and expects to achieve another surplus in the current fiscal year, although with difficulty and late budget cutting, which as noted above, is required by the State constitution. Like most states, Michigan is facing financial stress. At the end of FY2000, the State had amassed over \$3.9 billion in major fund cash reserves to deal with the recession. Today it faces a cash deficit of approximately \$400 million that it must finance by means of both internal and external borrowing. The State will achieve balance, but only after much political hand wringing.