

Keep Calm and Carry On

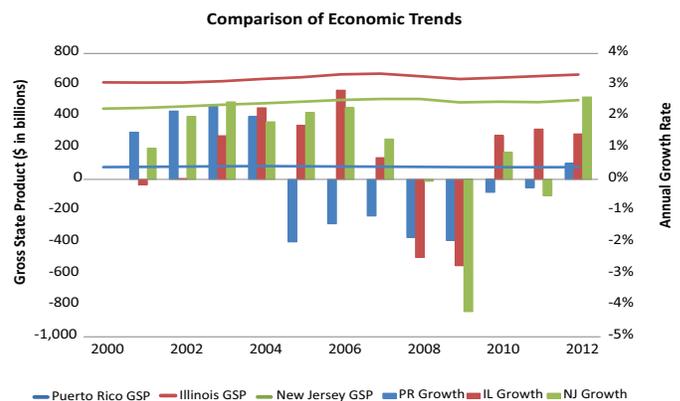
Every budget season is a battle between wants and needs. These battles are contentious, hard fought, and often in the public eye. Laying off public employees may be painful, but that is a far cry from defaulting on contractual debt payments. While politicians volley doomsday scenarios back and forth, they can create price volatility and widen spreads in the market. As investors, keeping political posturing and news headlines in proper perspective is important. So long as we are satisfied that an issuer continues to meet our stringent credit criteria, it pays to remain patient and earn the extra yield.

Right now, there are no truer examples of this practice than the budget battles underway in Illinois and New Jersey. These states are two of our larger holdings and the latest series of news items is not pleasing. Illinois' hard fought pension reform is now in the courts and the legislature has thus far failed to extend temporary tax increases which are due to sunset in January 2015. In New Jersey, Governor Christie has again overestimated the State's revenues and has used one-time measures, such as securitizing their remaining tobacco settlement payments and cutting pension contributions, to address the resultant budget gaps.

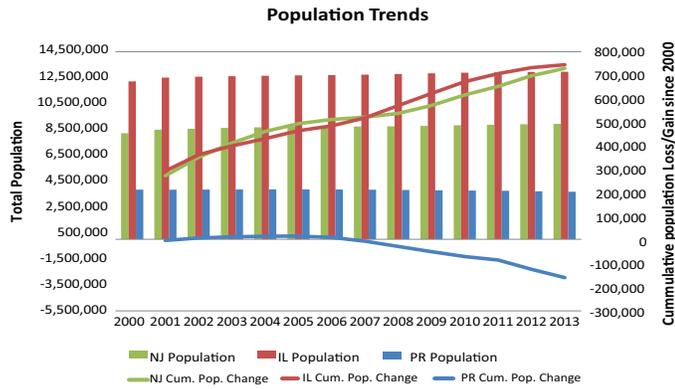
The budget travails of Illinois and New Jersey are not unusual for governments trying to find revenue sources to meet an ever growing list of wants. These wants include more funding for education, more government services, and more pay for its workers. Far more unusual are instances of distressed governments that struggle to fund their basic needs such as debt service payments, payroll, and essential infrastructure. While bankruptcies in the municipal sector are rare, the hallmarks of a distressed government credit are clear. The markers usually include a protracted economic decline, population flight, and gross mismanagement. These factors can lead to significant budgetary inflexibility. With this in mind, we must put the current budget battles in perspective with what a distressed state looks like.

Some media alarmists might start to draw parallels between the woes of Illinois and New Jersey to those of the Commonwealth of Puerto Rico, the closest entity to a state currently on the brink of insolvency. In fact, Puerto Rico has recently approved a framework for restructuring its electric, water, and highway agencies. There is no argument that both Illinois and New Jersey face large cyclical and structural budget challenges that require difficult solutions; however, a comparative look between the credit profiles of Illinois and New Jersey and that of Puerto Rico reveals stark differences in credit quality and just how far both states have to fall in order to impair their bonds.

First, there is the economy. In sheer size, Illinois and New Jersey rank near the top with gross state products (GSP) of \$721 billion and \$543 billion, respectively, as of 2013. Each is quite diverse with several significant industries contributing to employment such as mining, manufacturing and logistics in Illinois and pharmaceuticals, chemicals, telecom and insurance in New Jersey. This is in contrast to Puerto Rico's economy (\$103 billion), which would be ranked 37th (right after Mississippi) if it were a state. Both Illinois and New Jersey have generated moderate economic growth since the recession, albeit lower than our nation as a whole. In contrast, Puerto Rico has been



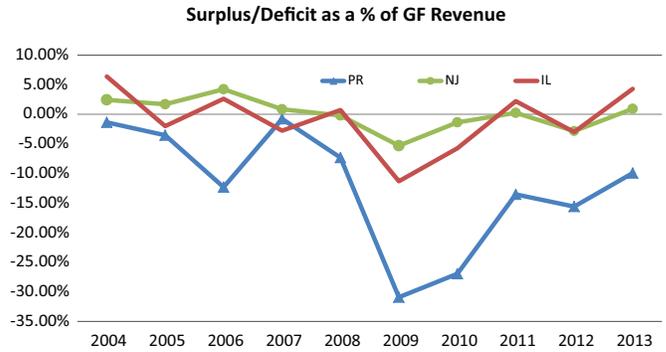
mired in a recession for most of the past 10 years, experiencing a cumulative economic contraction of close to 10%. Unemployment rates also highlight the stark contrast in these economies: 7.1% (IL), 6.3% (NJ), versus 13.1% (PR).



Source: United States Census

There are undeniable long-term linkages between demographic trends and growth. Much like Detroit, Puerto Rico is experiencing a troubling, accelerating emigration trend. In fact, since 2009 Puerto Rico's population has contracted by over 7%. We all know the effects of massive population flight on Detroit over the past half century. Fortunately, Illinois and New Jersey have experienced steady population growth over the last decade, albeit again modestly lower than that for the nation as a whole.

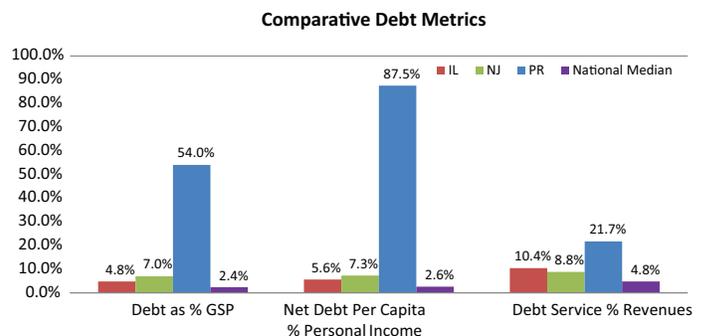
Aside from economic factors, management is one of the most crucial aspects of our credit analysis. Whether a state has a wealth of resources or not, its ability to manage within constraints determines whether it will have the budgetary flexibility to weather a variety of economic and financial conditions intact. While Illinois and New Jersey do not exactly epitomize fiscal management effectiveness, Puerto Rico occupies a niche of gross mismanagement all to its own. The budget deficits of New Jersey and Illinois, climbed as high as 5%-10% in the years following the Great Recession, resulting in rating downgrades and public scrutiny. However, this pales in comparison with those of Puerto Rico which has been plagued by deficits for over a decade ranging from 10%-30% in recent years. How those gaps are filled is also very telling. Illinois enacted temporary tax increases in 2011 to close a portion of its recurring budget gaps and implemented significant spending reductions. Even New Jersey's controversial \$90



Sources: Moody's Investors Service and BBH Analysis

million of deficit financing this year, which constituted less than 1% of its budget, is minimal compared Puerto Rico's \$800 million, which was more than 8%.

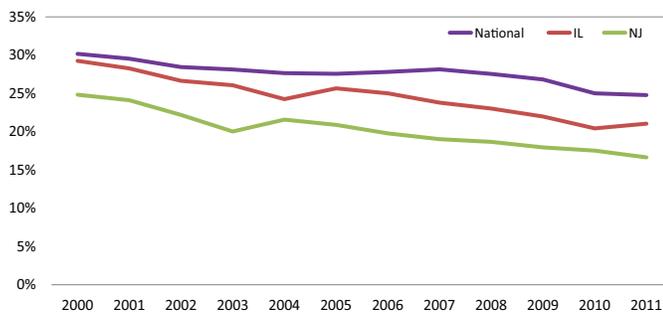
Economic and management factors ultimately impact budgetary flexibility. When utilizing a standard 30-year debt service schedule akin to those of other states, Puerto Rico's debt service payments would make up about 53% of its budget, nearly five times that of the manageable debt burdens of Illinois and New Jersey. By every measure – relative to population, personal income, and GSP – the debt burdens of Illinois and New Jersey, while often above national medians, are nowhere near the dire straits of Puerto Rico. This contrast is even more pronounced when including economic debt such as pensions and retiree healthcare. New Jersey and Illinois have unfunded pension liabilities of \$47 billion and \$95 billion, adding \$5,300 and \$7,400 debt per capita, respectively, or about 5%-10% of per capita income. Though almost entirely unfunded, Puerto Rico's pension obligations, at \$33 billion unfunded liability, representing \$8,900 per capita debt or about 90% of per capita income!



Sources: Comprehensive Annual Financial Reports for Illinois, New Jersey, and Puerto Rico; Moody's Investors Service, and BBH Analysis.

Another valuable source of financial flexibility available to Illinois and New Jersey's is their ability to push down

Intergovernmental Expenditures (as a % of State Spending)

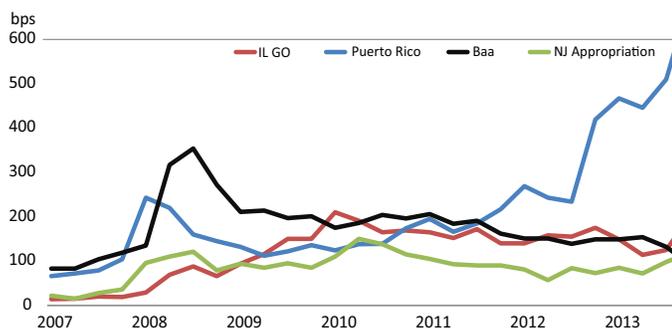


Sources: U.S. Census Bureau Annual Surveys of State and Local Government Finances (2000-2011) and BBH Analysis

expenditures to their underlying cities and counties. This flexibility is effectively not available to local governments who are often the victims of these types of budget cuts. The ability to reduce aid or pass expenditures down to the local governments is a powerful tool when managing budgets. Given its poorly developed local governments who have little revenue capacity, Puerto Rico effectively does not possess this flexibility.

There are the other structural protections that are important to us as bondholders. Illinois state statute gives debt service on general obligation bonds priority over other expenditures and requires the Treasurer and Comptroller to make the necessary payments from any revenues or funds of the state. In New Jersey, the state has traditionally relied on appropriation debt to meet capital needs. In fact, almost 90% of the state's debt service is subject to appropriation. While this structure does

Relative Value of Illinois and New Jersey



Sources: Thomson Reuters, Morgan Stanley and BBH Analysis

¹ Fixed Income obligations that include bonds, notes, loans, leases and other forms of indebtedness.

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introduce appropriation risk that general obligation bonds do not have, the indenture mitigates this by creating a senior lien upon any funds appropriated to its authorities. In other words, non-payment can only be achieved if the governor were to effectively cut all funding to important objectives such as education or transportation.

As bond managers, we worry about many things, and capital preservation is always first and foremost. The credits¹ we purchase must be durable and must be able to weather a wide range of future economic and financial conditions. If we ever become concerned about the ultimate solvency of a credit, we will avoid it. This is why we have not owned Puerto Rico. If there is a significant fundamental deterioration in a credit we own to the point our thesis no longer holds, we sell it. This is not the case with Illinois and New Jersey. Their recent budget problems have introduced a significant amount of short-term volatility, but we are focused on the long term. The ability to differentiate between politically-difficult budget decisions and those that could adversely impair bondholders enables us to take advantage of spread-widening for the benefit of our clients. In fact, valuations for Illinois and New Jersey are fairly comparable to that of BBB credits even though our opinion of their credit profiles is stronger. While more short-sighted bondholders might scramble to exit positions in the face of negative budget headlines for otherwise durable credits, we keep calm and carry on.

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