FROM THE OFFICE OF

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DANGER OF GUARANTEEING CALIFORNIA DEBT

In the next two months, the State of California intends to bring $15 billion in Tax & Revenue Anticipation Notes (TRANS) to the public marketplace. Due to the recent multiple downgrades of California's credit rating and deteriorating economic fundamentals, the State fears there may be no appetite to purchase new California debt. The purpose of this financing is to bridge the State's cash flow needs beyond July 2009. To enhance the offering's credit worthiness, the State is asking the US Congress to take the unprecedented step of backing the sovereign debt of the State of California with the Full Faith & Credit of the United States. There is a substantial risk that the AAA credit rating enjoyed by the United States would be cut if the US Government took this action.

EXTERNAL ECONOMIC ENVIRONMENT

The United States is in the midst of a severe recession, which began in 2007 and is expected to run through the end of 2009. The sectors of the economy most severely impacted by the recession continue to be real estate and finance. Considering California was at the National forefront of both sectors for the last decade, it is logical that the current contraction will have a disproportionately negative impact on the State.

The large monetary and fiscal intervention by the US Federal Government has cushioned the initial shock of the contraction and created a favorable basis for a moderate recovery of GDP next year. Nonetheless, it will probably be at least another 5 years for the real estate and financial sector to become positive generators of growth. Absent any structural change to the California economy, the State should anticipate a slower recovery than the US in general.

INTERNAL ECONOMIC ENVIRONMENT

For 35 years California has led the United States in GDP growth, job creation and standard of living. During these golden years, the State taxed, borrowed and spent itself into an increasingly uncompetitive economic position. Today California has the highest tax rates, second highest unemployment rate, highest total unemployed, lowest credit rating, highest fiscal deficit and least attractive business environment of any state in the Nation.

Although California leads the Country in net migration out of the State, it continues to enact new anti-business laws and environmental mandates. The increasingly negative business climate and punitive consumer tax structure contributes to the State's increasing deficits. Because the State has historically been able to borrow its way out of cash flow shortfalls, there has been no pressure to change this broken model.

PROPOSITION 13

The State of California has historically relied on taxing real property and income to fund its operations. In 1978, a taxpayer revolt resulted in the passage of Proposition 13, which limited the increase on assessed valuations of existing properties to 2% annually. Consequently, the State increasingly relied on income tax, especially capital gains taxes, to fund budget growth.

The broad decline in real estate prices from 1990-97 predictably resulted in a significant drop in revenue for California. One of the biggest victims of the recession was the County of Orange. The County maintained its spending levels, even as revenue contracted, by increasing its reliance on speculative short-term investment earnings. Although the investments helped cover costs in the short run, the scheme ultimately proved to be a disaster and the County was forced into bankruptcy. When the County's efforts to raise sales taxes were rebuffed by voters, operations were restructured to be more efficient. In spite of a 20% revenue reduction, services continued largely uninterrupted and at a level which met all legal requirements.

CAPITAL GAINS FROM STOCKS AND REAL ESTATE

From 1997-2001 Silicon Valley was the center of the universe. Capital gains taxes, a byproduct of soaring internet stock prices, filled California's coffers. The newly created wealth resulted in higher consumer spending, increased auto sales and record revenues for California. It also fueled a dramatic expansion of government programs.

When revenues fell off a cliff in fiscal year 2001-2002, the Governor and California Legislature sought to create new taxes to fill the budget short fall. Working together, they increased the marginal tax rates on high-income earners and tripled the vehicle license fee (VLF) for all car owners. The combination of progressive and regressive taxes, were wildly unpopular and led to another taxpayer revolt. The Governor was recalled, the VLF tax was rescinded and legislation was passed that permitted $10 billion of long term borrowing to plug a current year deficit.

For the next 5 years, consumer spending and car sales accelerated, while real estate capital gains exploded. The spike in tax revenue allowed the State Legislature to increase spending at twice the compounded growth of the State GDP.

THE END OF CAPITAL GAINS

Spurring the growth of the California budget was the State's phenomenally large capital gains tax base. The top one percent of earners generates 40% of the states revenues; 250,000 people have been doing the heavy lifting for a state with a population around 36 million.

From 1994 to 2007, this top-heavy tax system flourished as virtually every class of investment vehicle, including stocks, residential real estate, commercial real estate, commodities, art, collectibles, oil, gold and US Government bonds participated in a bull market. During this period of economic expansion, the state was collecting roughly $25 billion in capital gains driven taxes.

Since the middle of 2008, most investments have declined precipitously in value. The losses associated with all investments have created tax-loss carry forwards that will offset about 80% of any capital gains tax liabilities for the next 5 years.

TAX AND SPEND

In late 2008 the California State Controller's and Treasurer's offices began warning that worsening economy would inevitably result in significantly diminished revenues. The Legislature responded to this grim outlook by increasing regressive State taxes, expanding State employee head-count and passing new business restrictions. In order for the Legislature's budgetary house of cards to stand, voters must approve a series of new taxes when they go to the polls May 19. The Legislature's tax, borrow and spend initiatives will fail, according to all recent polling data.

STATE REVENUE CASH FLOW

The State of California's cash flow balances rise and fall annually on a predictable cycle. Consumer sales and new model car sales generate very large sales tax and VLF revenue at the end of the calendar year. Tax revenues are paid to schools and other beneficiaries in January and reserves thus hit a low point in February.

Income and property tax collections begin in March and the State's reserves hit their annual high point in April. Reserves then decrease each month until they hit their annual low point in September.

To smooth cash flows availability, Federal Law permits the State to sell TRANS with maturities up to 210 days, or until sufficient revenue is collected to match spending activity. If the State does not have the resources to pay beneficiaries of State spending on a timely basis, the Legislature may delay the distribution of apportionments to beneficiaries.

WARRANTS AND RAWS

If the State is unable to borrow money to meet their obligations, the State Controller can issue unsecured warrants, which are IOUs to vendors. The State can also sell Registered Anticipation Warrants (RAWs), which are promises to pay on a daily priority basis as cash flow is available. It is a felony for the State Controller to fail to pay RAWS as cash becomes available. RAWs would be extraordinarily attractive to investors because their priority is criminally protected against non-payment; default is not an option!

The RAWs that were issued in the last 30 years were met with strong ratings and exceptionally strong investor demand. The State has resisted issuing RAWs in the past, because RAWs require fiscal discipline; as revenue is collected cash must be immediately paid out to creditors.

Moody's and S&P have both assigned an A rating to the State of California. Given that TRANS are sold to money market funds that require a minimum rating of AA, there currently is no market for California TRANs. Issuing RAWs appears to be the only way for the State to meet its cash flow needs.

ORANGE COUNTY TREASURER BRIDGE LOAN TO SCHOOLS

Starting in August of 2008, the Orange County Treasurer's Office recognized the State may have cash flow shortages at its cyclical in February 2009. Some California K-14 schools, with insufficient reserves, were at risk of not being able to pay teacher and staff salaries. Considering all California school districts offer each teacher an individual employment contract by March 15 for the upcoming Fiscal Year through June 30th, some schools would have to shorten the school year or renegotiate every individual teacher's contract (impractical).

Working in concert with the other County Treasurers, Orange County was able to structure a $3.5 billion Bridge Loan, to be secured with School Warrants. This likely would have been enough cash for most California schools to complete their full school year, in the absence of a State budget. A State budget was ultimately passed.

COMPROMISE TAX INCREASE

In late February 2009, the California State Legislature signed a "compromise" State Budget that substantially increased taxes, and placed tax and borrowing measures on the May 19th ballot. Although the State is required to annually pass a balanced budget with a $2 billion reserve, most State financial officers' estimate the budget will be billions in the red, even if all the initiatives passed.

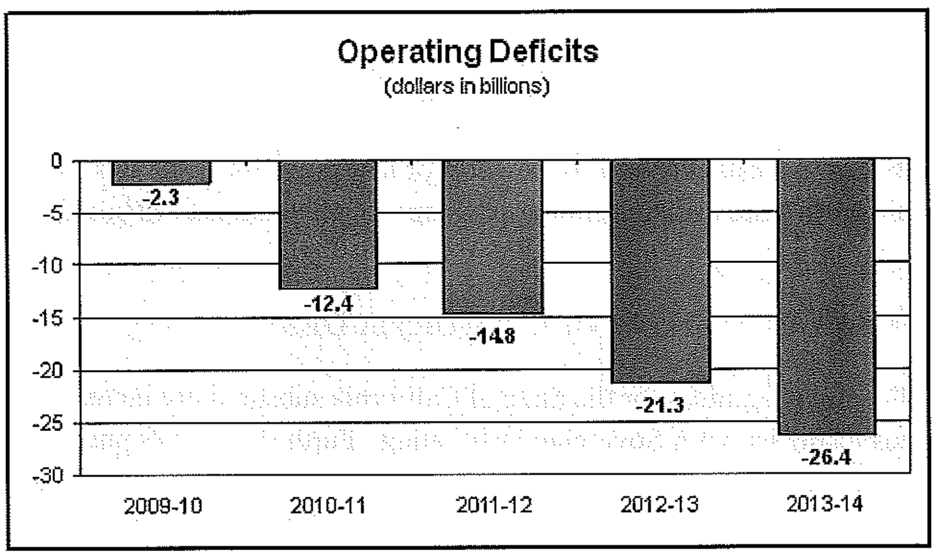
Furthermore, the current budget curiously assumes that property taxes will continue to increase at 5%, while most County Treasurers forecast their collections to be flat or negative this year and down an additional 5% next year. The California Legislative Analyst March 2009 forecast is enclosed.

California State Debt Issuance

The Treasurer of the State of California has sold $10 billion of bonds so far this year. Bonds issued at the beginning of the year yielded 4%, but this most recent offering saw rates with yields up to 6%; a 200 basis point increase in just a couple months!

California now has approximately $60 billion of debt outstanding. The vast majority of the bond sales have been to individuals. Each sale of bonds included financial projections regarding the State budget that appear to have been incorrect, or unreasonably hopeful, at the time of issuance

Further borrowing by the State of California, will make higher taxes a necessity. If the Legislature fails to keep spending in line with State revenues, California risks defaulting on their bonds. The March 2009 pro forma published by the California State Legislative Analysts Office (LAO) estimates that the State of California would face a new $2 billion operating shortfall for Fiscal 2009-10 and a $76 billion of annual deficits over the next 5 years (exhibit below).



These projections may be extraordinarily optimistic. The LOA's forecast assumes that all the revenue generating in initiatives on the May 19th ballot pass and that assessed property values continue to rise. As of today the ballot initiatives are trailing badly in the polls and property values continue to decline

Additional Budget Risks

No commercial bank or insurance company is currently willing to provide credit enhancement to increase the rating of the State of California. The common response from lenders is that California appears to be heading for further downgrades. Lenders are concerned that exposure to California debt may drag down their own credit rating.

Issuance of RAWs

There is a substantial pool of buyers for California State Revenue Anticipation Warrants. The interest rate cost to issue RAWs would be more favorable than that of recent debt offering. The only impediment is that the State Legislature fully understands issuing RAWS would legally require fiscal discipline.

Do No Harm

California counties, schools and other municipal entities are required to maintain reserves by law. These reserves will cushion the State's "failure to fund" mandated services for at least six months. The Orange County Treasurer's office believes that the $7 billion investment pool that they manage, would allow the County of Orange to continue to operate for over nine months, absent any State support.

K-14 schools also have the right under California Law to borrow from their County Treasurer under certain conditions. In September 2008, the Orange County Treasurer's office negotiated terms and conditions and established a framework for lending to local schools. School districts in the State of California are utilizing similar language to seek authority to borrow from their County Treasurer.

US Government Guarantee of California Debt

Providing US Federal guarantees for the State of California substantially increases the RISK of the United States losing its AAA Sovereign Debt rating. Furthermore, US guarantees of California State debt would have a material adverse effect on the ability of all other municipality and state borrowers to fund, due to a "crowding out" effect; interest rates would soar for non-Federal-guaranteed debt. The United States government will inevitably become the lender of "last resort" for all government entities in California and across the United States as the contagion devastates other government issuers.

If the US government decides to aid California, it should buy RAWs, not guarantee the State's debt. RAWs will insure that all investors get paid on time. Purchasing RAWs give the US government an avenue to aid California, without establishing a precedent that could destroy the US government's credit worthiness.