

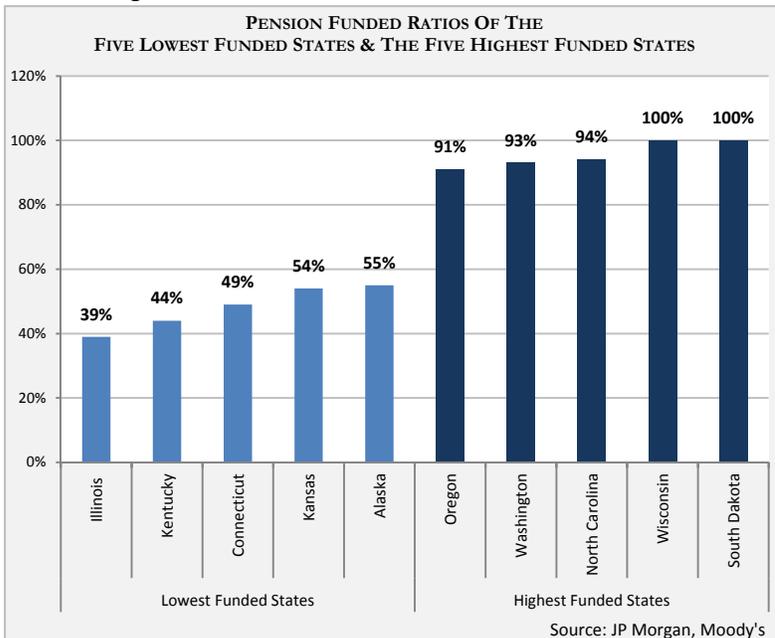
RATING AGENCY	CURRENT RATING	OUTLOOK
Moody's	A3	Negative
S&P	A-	Negative
Fitch	BBB+	Stable (downgraded 10/19/15)

The State of Illinois is subject to ongoing market volatility and potential downgrade risk as the State continues to delay addressing their pension funding crisis. The low pension funding levels, budget imbalance, and clear lack of political will are the primary factors overhanging the credit. The Governor and Legislature have failed, since the July 1st start of the fiscal year, to agree on a budget and set a spending plan in place. The lack of a budget is adding further negative pressure on the State, and each day without a budget exacerbates the growth in negative trends.

The confluence of events occurring at the state level that are adding downward pressure on the State's trading levels, outlook, and potentially to the State's ratings include:

Low Pension Funding Levels and Growing Liabilities

- Illinois stands out as having the lowest funded pension systems of all 50 states. The Supreme Court ruled earlier in 2015 that pension reform legislation passed by the State in 2013 violated the State's constitution, specifically the pension clause which explicitly states that pension benefits are a contractual relationship and cannot be impaired. This is one of the strongest protections afforded by any state and seriously limits the State's flexibility in dealing with the funding crisis.



Stalemate Over Addressing the Budget Deficit

- The overall lack of political will is highlighted by the standoff that exists over a current, fiscal 2016 spending plan. Republican Governor Rauner, and the Democratic controlled legislature, which has a supermajority in both houses, remain at odds over a budget almost four months into the fiscal year. An estimated \$5 billion deficit exists, and the two sides are conflicted over how to fill the gap and set the course for spending in 2016. The legislature allowed a 2011 tax increase to expire at the end of 2014, adding to the budget deficit by eroding an increased source of revenue.

Unpaid Bills Accumulate as Payment Priorities Take Hold

- Illinois is currently facing a liquidity crisis, and without a spending plan for fiscal 2016 agreed upon and in place, the state Comptroller has to manage cash and make payment priorities. With almost 60% of current spending being continuing appropriations, court ordered or consent decrees, or noted as high priority, payments made into the pension system are deemed "flexible." The \$550 million payment for November will not be made due to the cash shortfall, and the December payment is in question. While the Comptroller has stated that the payment(s) will be made up before the end of the FY in June, 2016, it further highlights the unintended consequences of political gridlock.
- As each day passes without a budget in place, a cash shortfall and the need to set payment priorities are causing the State's unpaid bills to accumulate. The Comptroller currently estimates unpaid bills of \$6.9 billion versus \$3.5 billion at the end of July.

The State continues to reinforce that debt service on the State's GO bond obligations is constitutionally their highest priority of payment, so the risk of non-payment on GO debt is minimal.

Given the strong priority of debt service payments, we believe a payment disruption on GO debt service is unlikely, although further spread widening and/or downgrade risk exists. In addition, debt service payments are subject to a continuing appropriation, so the budget impasse and restriction on paying certain bills does not impact payments on the State's GO debt.

Appleton does not currently buy or own general obligation debt of the State of Illinois. We will continue to monitor the credit developments in the State and watch for potential investing opportunities should conditions warrant.