Investment Perspectives

An Update on California's Fiscal Picture for Muni-Bond Investors

While the state faces a well-publicized budget shortfall, its fiscal management has allowed it the flexibility to address the situation.

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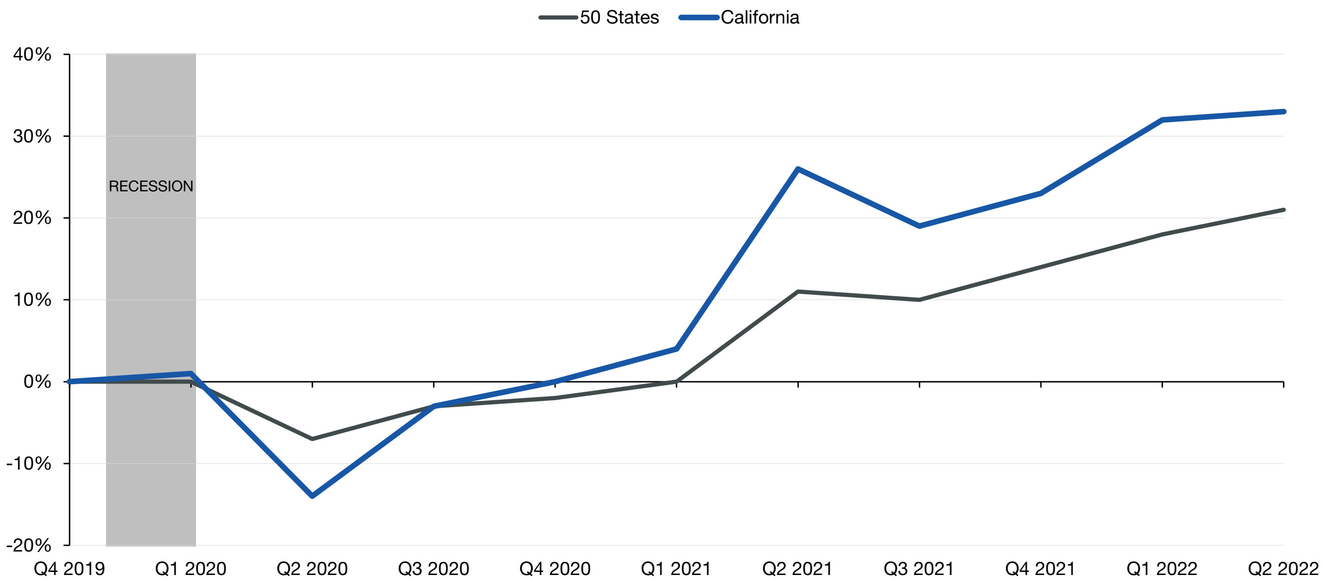
Seeing daily headlines about how the state of California plans to close a $32 billion budget deficit[1], it is easy to forget that one year ago those headlines were about the state's $98 billion budget surplus[2] and how to spend it.

California's reserves swelled to historic levels during the COVID-19 pandemic due to the far higher-than-expected tax revenues and an influx of $36.5 billion in federal aid from the CARES and ARPA stimulus packages.[3] (See Figure 1.) While the state has begun to draw down a portion of these reserves to further its long-term policy goals, the overall fiscal resilience of state and local agencies remains historically strong.

Figure 1. California's Tax Revenues Increased Dramatically in the Post-Pandemic Period

Change in tax revenue for the indicate periods (Q4 2019=0)



Source: Pew Charitable Trusts. For illustrative purposes only.

Prior to the pandemic, California's reserves had exceeded 10% of annual expenditures in only two of the past 30 years—2000 (13.6%) and 2001 (11.0%). Reserves during this prior period, built on billions in unbudgeted capital gains tax revenues during the upswing of the dot-com bubble, were spent nearly as quickly when the bubble burst. Today's high level of reserves—the state's latest estimates for the end of the 2023 budget year are 20.7% of expenditures—were not built on the back of market euphoria but through conservative budget management and the continued strength of the state's economy.

A Closer Look at Tax Revenues

Income taxes provide the majority of the state's revenues. In the first few months of the pandemic, as the unemployment rate was spiking above 15%, the state was quick to respond by revising tax revenue expectations down and cutting planned expenditures. Between January 2020, when the 2020-21 budget was proposed, and June 2020, when that budget was enacted, the state revised its estimate for income tax revenues down by $25 billion and cut about $20 billion in planned spending. By the end of budget year 2021, however, actual income tax revenues had come in $26.6 billion higher than the pre-pandemic estimate and more than $50 billion above budget.

Wary of committing these unbudgeted surplus revenues to ongoing spending increases, state lawmakers negotiated and approved plans to place about $8 billion in the government's Rainy Day Fund, bringing the total balance to $22.2 billion (the maximum currently allowed under state law), and to spend the remainder on one-time projects that wouldn't require the support of future revenues. Examples of these one-time spending items are the stimulus checks that the state sent out to millions of residents, as part of a $17 billion inflation relief package in 2021-22, and the $10 billion committed over five years to enhance the state's zero-emission-vehicle infrastructure.

As economic growth has slowed and state tax revenues have slightly underperformed in 2023, budget discussions have turned from where to increase spending to where to cut back. The fact that the past year's surpluses were committed mainly to one-time projects and not to expanding or adding ongoing services makes it easier for the state to adjust those commitments to reflect the evolving economic realities.

Key Trends in Property Taxes, Revenue Bonds

While the state generates most of its revenues from income taxes, cities and counties rely on property taxes to fund most of the services they provide. Numerous headlines have highlighted the weakness in Bay Area commercial real estate over the past few months, but we view this stress as isolated to that region and unlikely to affect even those municipalities more than marginally due to the unique way that California assesses property values.

Since 1978, an amendment to the state's constitution known as Prop 13 has capped the amount that a property's taxable value can increase at 2% annually, unless the property changes hands. Over the ensuing decades, that cap has gradually created a generous cushion between the assessed value (the value that is taxed) and the market value (the value the property would sell for on the open market) of real estate in California. While Prop 13 therefore prevents local governments from immediately reaping the full benefits of hot real estate markets, it also provides for consistent and predictable tax revenue growth, even in years when market values are declining. The experience of San Francisco during the global financial crisis provides a dramatic example of this effect—despite the median home price falling by 20% between 2007 and 2011[4], the city's property tax revenues grew by 23% over the same period.

California was the first state to impose COVID-19 restrictions, and that stricter environment, combined with the continued embrace of remote work by tech companies, have contributed to slower traffic recovery on its roads and at its airports when compared with the rest of the United States. Despite these headwinds, the state's transportation agencies were able to minimize the impact on their revenues by passing through operating costs and raising fares, keeping the credit quality of these issuers stable as well. Even as global air travel ground to a standstill, revenues of municipal airports fell only marginally between 2019 and 2020 because cost-sharing agreements with airlines allowed these facilities to automatically recoup much of the revenue that would have otherwise been lost. Municipal toll roads were able to minimize revenue losses by hiking toll rates, and some saw increases in higher-paying commercial/trucking traffic as "work from home" turned into "buy from home."

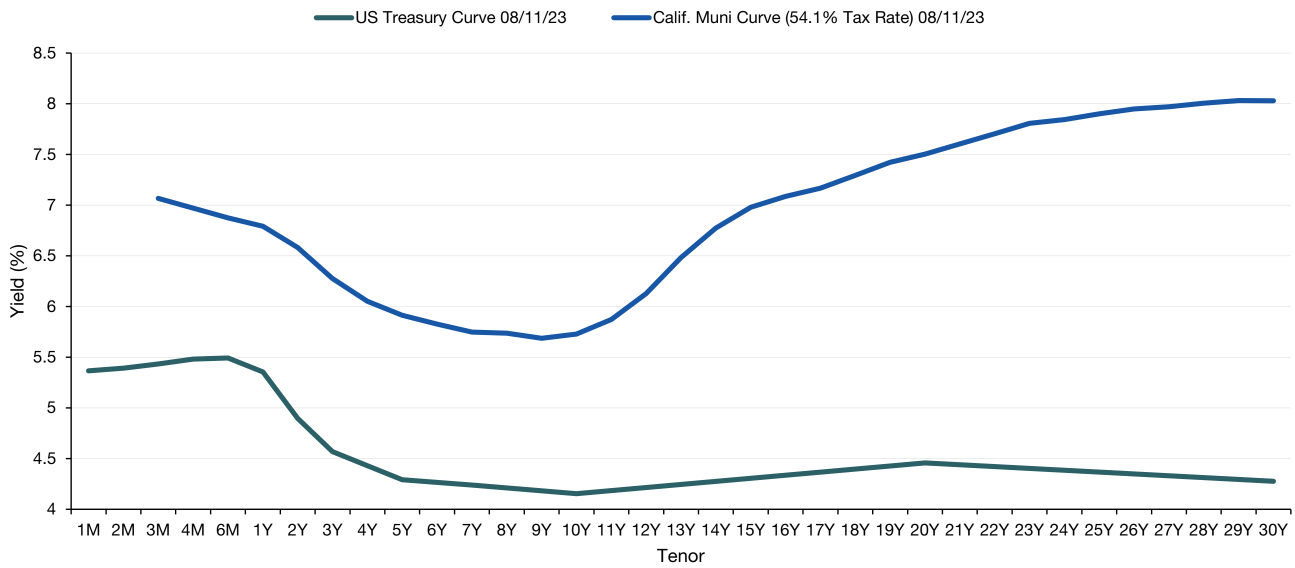
An Attractive Opportunity

Despite the impressions left by headlines of multi-billion-dollar deficits and discounts on Bay Area office buildings, the fiscal health of California—and the majority of its local government agencies—remain very strong. By committing the extraordinary surpluses generated during the pandemic years to one-time projects, and not to funding ongoing spending or to cutting tax rates, the state should retain significant financial flexibility while still furthering its policy goals.

Given the uncertainty surrounding the economy and the headlines surrounding California's budget, many municipal bond investors have chosen to stay on the sidelines waiting for a better entry point. Investors should take notice of the compelling yields offered to California residents in-state for those that are in the top tax brackets, and these higher yields have the ability to increase the after-tax returns of their associated portfolios, given the high tax rates. Furthermore, while many investors are aware of the "yield curve inversion" in the U.S. Treasury market, investors can gain significant incremental yield by focusing on intermediate and longer-term maturities in California municipal bonds due to the steeper municipal yield curve. (See Figure 2.)

Figure 2. Attractive Yield Opportunities in Longer-Dated California Municipal Bonds

Yield curve (tax-equivalent yield basis for California municipal bonds) for indicated maturities as of August 11, 2023



Source: Bloomberg. Yield data for U.S. Treasuries based on the Bloomberg U.S. Treasury Actives Curve. California municipal bonds represented by the Bloomberg US California Muni BVAL Curve, which is constructed daily with bonds that have BVAL prices at the market close. The BVAL curve is populated with U.S. general obligation municipal bonds issued by the State of California. California municipal bond yields are presented on a tax-equivalent basis and reflect a 54.1% tax rate: 37% Federal + Medicare 3.8% + 13.3% California resident tax rate. Tax-equivalent yield may be different for other tax brackets and jurisdictions. A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. Tenor refers to the time to maturity of a debt issue.

Past performance is not a reliable indicator or guarantee of future results. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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[1]Taryn Luna, "What You Need to Know about Newsom's Plan to Offset California's $31.5-billion Deficit," Los Angeles Times, May 12, 2023.

[2]John Myers, "California Surplus Expected to Hit Unprecedented $97 Billion Under Newsom's Budget Plan," Los Angeles Times, May 13, 2023.

[3]Source: U.S. Treasury Dept. The stimulus programs referenced are the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) and the American Rescue Plan (ARPA).

[4]Source: Metropolitan Transportation Corp. (Bay Area, Calif.) via Zillow

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Glossary & Index Definitions

General obligation (GO) bonds are backed by the "full faith and credit" of a government, and are issued by entities such as states, cities, counties, and school districts. Revenue bonds are backed by revenues from a specific projects or facilities (such as toll roads, water/sewer systems, or airports).

Rainy-day funds, also known as budget stabilization funds, allow states to set aside surplus revenue for use during unexpected deficits.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price. Tax-Equivalent Yield is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of a tax-free municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond in order to see which bond has a higher applicable yield.

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