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California Bond Costs at 2007 Low on Rainy-Day Vote: Muni Credit.

California won its lowest borrowing cost since 2007 in a $1.2 billion sale of general obligations, signaling that investors are rewarding Democratic Governor Jerry Brown's push to bolster the state's finances.

The deal yesterday was California's largest via auction in seven years. It included tax-free bonds maturing in November 2024 that priced to yield 2.4 percent, compared with 2.25 percent for benchmark debt, data compiled by Bloomberg show. The spread of 0.15 percentage point is down from about 0.4 percentage point in October 2013 and the lowest since April 2007, before the financial crisis led the state to resort to IOUs to make ends meet.

Through higher tax rates and a newly bolstered rainy-day reserve that socks away revenue during boom times, California's creditworthiness has improved more than any U.S. state since the recession ended in 2009. The three biggest rating companies have raised it four times in the past two years, including last week's boost by Standard & Poor's to A+, the fifth-highest mark.

"Jerry Brown is pushing through some substantive changes and reform that we think is going to put the state on solid footing for many years to come," said Scott Sprauer, who helps handle a California fund in Princeton, New Jersey, for MacKay Municipal Managers, which oversees $12.2 billion in munis. "They can continue to see increases in credit ratings in the years ahead."

Rating Reward

S&P raised the rating the day after voters re-elected Brown, 76, as governor, and approved a fiscal plan that he championed. The measure sets aside 1.5 percent of general-fund revenue each year into a rainy-day reserve, as well as capital-gains taxes that exceed 8 percent of the fund.

The approach addresses rating companies' criticism that California was failing to put aside money when the economy surged and relying too heavily on volatile capital-gains levies.

The decline in relative borrowing costs underscores the fiscal recovery. As deficits soared in 2009 and California covered expenses with IOUs, investors demanded a record 1.71 percentage points of extra yield to own its 10-year debt instead of AAAs, more than 10 times this week's level.

California's spreads are approaching those from higher-rated states. Ten-year bonds from Florida, graded AAA by S&P, yield 0.14 percentage point more than top-ranked munis, Bloomberg data show. Debt from Washington, graded one step below AAA, yields 0.17 percentage point more than the benchmark.

Crisis Benchmark

"Spreads have gotten to the point where they're almost at the pre-crisis levels," said Jim Noble, who manages a California fund in New York at Principal Global Investors, which oversees $4.5 billion in munis. “It’s a lot of tightening in a short period of time.”

The pricing looks even better as benchmark rates climb. Ten-year AAA yields rose to 2.26 percent today, the highest since Sept. 23, Bloomberg data show.

California has gone from a $25 billion deficit three years ago to a $3.9 billion surplus going into this fiscal year. Brown boosted spending in the world’s eighth-largest economy to a record $156.4 billion this fiscal year while depositing $1.6 billion into a rainy-day fund, the first installment since 2007.

Voters have helped propel California’s rebound. In 2012, they approved higher taxes on income and sales to limit cuts to welfare and education.

Valley Payday

The steeper taxes and a resurgent economy fueled by Silicon Valley have plowed $20 billion into the treasury and will produce an additional $24 billion before the sales-tax boost runs out at the end of 2016. The income-tax increase expires two years later.

Since the beginning of the fiscal year in July, revenue has exceeded Brown’s projections by 4.5 percent, or $1.2 billion. Brown and lawmakers are also on schedule to pay off half of the $34.7 billion of loans, deferrals and accounting gimmicks used during the last decade to cover deficits.

The tax increase “was the first step that showed Jerry Brown was going to have the ability and political backing to push through measures to really shore up the state,” Sprauer said.

California remains the most-indebted U.S. state, with $87 billion of bonds paid from the general fund, more than double a decade ago, according to data from the state. Voters last week approved $7.5 billion of bonds for water infrastructure.

Highlight Reel

Yesterday’s deal was in three parts: $630 million of tax-exempt debt for capital investment, $306 million of tax-free refunding bonds and $270 million of taxable securities for new projects. The offering documents highlight the passage of the rainy-day reserve amendment.

The narrower spreads defy a broader weakening in munis as yields climb after an unprecedented streak of gains this year. State and local debt has declined about 0.2 percent this month, on pace for the first monthly loss since December, Bank of America Merrill Lynch data show.

The fiscal gains and demand from residents for tax-free debt offset the market decline, said James Welch at Principal Global. Debt of California issuers has earned about 9 percent this year, compared with 8 percent for the broader municipal market, Barclays Plc data show.

“It seems like a perfect environment for California to come to market,” Welch, who manages munis for Principal from New York, said before the deal. “There’s clearly appetite.”

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