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## California's Governor Race Has Bond Investors Worried.

- **Top gubernatorial candidates lack specifics on fiscal plans**
- **Angst mounting about what happens when boom turns to bust**

Saying goodbye to Jerry Brown is tough for the bond market. A progressive with a frugal bent, the Democratic governor won fans on Wall Street. As analyst Ben Woo put it, "He is the one who saved California."

So far, his potential successors aren't making the farewell any easier.

The Democratic frontrunners vying to replace him, Gavin Newsom and Antonio Villaraigosa, have been long on policy promises but, according to bond managers, short on specifics about how they would keep the budget balanced in a state with a \$2.75 trillion economy. That's worrisome to investors eager to avoid a return to deficits, especially given that California's current boom will inevitably cool.

"The state is pretty well prepared right now. Is the next governor going to squander that?" said Jennifer Johnston, a research analyst in San Mateo, California, for Franklin Templeton Investments, which manages more than \$65 billion in municipal debt.

Brown, in his second stint as governor, can be viewed as a tough act to follow from more than just an investor perspective. The 80-year-old has over the last 16 months become the outspoken chief of blue states' resistance to President Donald Trump's policies on everything from immigration to climate change. California has challenged the U.S. government at the pace of two lawsuits per month since Trump's inauguration.

But on Wall Street, Brown is best known for whittling away the \$27 billion budget deficit he faced as he took office in 2011 — a time when pundits were comparing California to debt-ridden Greece — and turning around state finances with spending cuts and voter-approved tax hikes. California's credit rating, once the lowest in the nation, rose to AA-, its best showing since 1999, according to S&P Global Ratings. Officials are estimating a \$6 billion surplus in the year that starts in July. Meanwhile, the state's economy has become the world's fifth-largest.

Woo, a senior analyst at Columbia Threadneedle Investments in Minneapolis, said his firm bought more California bonds in 2012 thanks to Brown's handling of the financial crisis. Now that the economy is in vastly better shape, he said it's a "tall order" to expect the next governor to share Brown's fiscal discipline.

Voters will pick the candidates in a June 5 primary. As of 2012, the two top vote-getters advance to the general election regardless of party, which could result in an unprecedented match-up of two Democrats for governor. With 27 candidates and many undecided voters, polls have suggested a variety of outcomes.

### **'Dodging Questions'**

The one consistency has Newsom, a former mayor of San Francisco and the current lieutenant governor, holding a comfortable lead for a spot in the general election. Villaraigosa, mayor of Los Angeles for two terms, ranks second in several surveys, with state Treasurer John Chiang next in the running for Democrats. Among Republicans, the leader is John Cox, a businessman who has never held political office.

The Democratic leaders have talked about easing the state's dire housing shortage, alleviating the homeless crisis and boosting the education system. Bond managers' complaint is that they haven't said enough about how they would pay for such initiatives, nor what they would do in a recession, which Brown himself has repeatedly warned is due to come.

"They're all dodging hard questions," said Ksenia Koban, a municipal-credit analyst at Payden & Rygel Investment Management in Los Angeles.

### **Single Payer**

When asked about the criticism, Newsom said his focus on implementing single-payer health care — a goal favored by the most liberal wing of the Democratic party — proves that he's concerned about the bottom line. While municipal bond analysts see such a move as inherently risky to the state's finances, if even possible under a Trump administration, Newsom said it wouldn't be as expensive as the current system that he deems unsustainable.

"If you care about fiscal discipline, if you care about unfunded liabilities and if you care about the growth of government and costs, this issue has to be tamed," Newsom, 50, said in an interview.

Villaraigosa and Chiang have criticized Newsom's push as irresponsible without a detailed funding plan, portraying themselves as the best to carry on Brown's legacy of fiscal conservatism.

Villaraigosa, 65, pointed to his tenure as mayor of Los Angeles from 2005 to 2013, saying he negotiated higher pension contributions from city employees, laid off workers and reduced deficits to avoid bankruptcy. "I have been a strong fiscal steward of taxpayer dollars," he said. (Michael Bloomberg, founder of Bloomberg News parent Bloomberg LP, has donated \$1.5 million to an independent campaign supporting Villaraigosa.)

Chiang, 55, said he's a "progressive who can handle a checkbook." He cited his moves as controller to withhold the pay of lawmakers for failing to settle on a balanced budget on deadline, and issuing IOUs as the state faced a cash crunch during the last recession.

### **Spending Criticism**

The wild card is Cox, who placed second behind Newsom in two recent polls. He has railed against current fiscal policies, saying in an interview that only compared to the "spendthrifts" in the Democrat-led legislature can Brown be considered frugal.

"Spending in California is out of control," said Cox, 62. "The tax burden has gone up tremendously. That's hardly fiscal responsibility."

Should Cox advance, he'd likely face a serious challenge going against Newsom or Villaraigosa in the general election, considering that 45 percent of California's voters are registered Democrats and only 25 percent are Republicans. The other likely pairing is Newsom versus Villaraigosa, and both have yet to show the same level of fiscal discipline as Brown, said Matt Fabian, a partner with research firm Municipal Market Analytics.

“Investors in California have to assume that credit quality could erode,” he said.

Payden’s Koban said the main issues the next governor will face, and that the candidates aren’t addressing, are rising pension costs, an aging population and a tax structure that limits the financial flexibility of cities during a downturn. But residents, much less politicians, aren’t focused on them.

“The problems coming down the pipeline are severe,” she said. “We’re not quite there psychologically as Californians because things are looking rosy and the economy is booming.”

## **Bloomberg**

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