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California Investors Fear Return to Deficits as Governor Jerry Brown Departs.

- **Bond buyers want frontrunner Newsom to show fiscal prudency**
- **Democrat would take charge as prospect of recession looms**

The fiscal contrast between California Governor Jerry Brown and Gavin Newsom, the frontrunner to replace him, may best be shown through a decades-old program to fight blight.

Facing a $25 billion budget deficit, Brown entered office in 2011 with a cost-cutting plan that included killing hundreds of redevelopment agencies. Eight years later, Newsom is poised to inherit an almost $9 billion surplus. One of his campaign planks: bring the agencies back.

That kind of divergence is making bond investors in boom-and-bust California nervous. Newsom, a Democrat who is seen as coasting to victory over a Republican businessman, would have to balance campaign promises against the threat of a return to massive deficits.

“The fear is, will Gavin Newsom be able to enforce the discipline that Brown had?” said Eric Friedland, director of municipal research at Lord Abbett & Co., which oversees about $20 billion in munis. Loosening the budget would “be problematic, as we’re probably going to be facing an economic slowdown.”

There are 36 state gubernatorial elections on Nov. 6, and while California’s race isn’t exactly a nailbiter, it’s viewed as one of the most important. The state is the most populous in the U.S., boasts the fifth-largest economy in the world and is the country’s largest issuer of municipal bonds — with $73 billion in general-obligation bonds outstanding as of the beginning of the month.

Newsom, currently the lieutenant governor, is up against John Cox, who has never held political office. Cox has trailed in all independent polls and faces an uphill battle in California, which hasn’t elected a Republican to statewide office since 2006.

Wealth Disparities

Newsom, 51, has cited his previous experience as San Francisco’s mayor to support his pledge of fiscal responsibility. In a debate with Cox on public radio station KQED earlier this month, he said that his biggest concern is “addressing the income and wealth disparities in the state, in a way that doesn’t begrudge other people’s success but addresses these issues in a systemic way.” He declined to be interviewed for this story.

For investors, the question is just how long the market for California bonds will remain robust amid the leadership turnover and a potential recession. Wealthy Californians have clamored to own municipals as a tax shelter after last year’s federal tax overhaul curbed some of their deductions. That’s pushed yields on some state securities to levels close to those for top-rated bonds.

“Over time, as the credit begins to deteriorate, it could have some impact,” Friedland said. “Right now, California bonds are very, very rich.”

When Brown took office in 2011 — he also served two terms after Ronald Reagan was governor — California was the lowest-rated U.S. state and sparking grim comparisons to debt-ridden Greece. He presented what he called a “tough budget for tough times.” The elimination of redevelopment agencies, which had reversed blight but also embarked on dubious ventures such as golf courses, shifted property-tax revenue to schools and other purposes.

The state’s fiscal turnaround has been striking, bolstered by Brown’s spending cuts and voter approval of higher taxes that were billed as temporary but later extended through 2030. Fueled by Silicon Valley’s technology industry and a real estate revival, California’s economy has outpaced the nation’s since 2012.

Tax Reliance

The higher personal income tax rates for wealthy residents, however, have made the budget even more susceptible to fiscal downturns. When markets tumble, so do capital gains — and the state’s revenue.

Although Brown has padded the rainy-day fund to about $13.8 billion — the constitutional maximum approved by voters — it won’t be enough to completely absorb the effects of a moderate economic downturn, according to the Legislative Analyst’s Office. And after the second-longest expansion on record, some economists are expecting a recession by as soon as next year.

The next governor “stands a chance that four years from now, the state may be in a worse off position than what he’s coming into,” said Carol Flynn, co-head of the municipal bond department at DWS, which manages about $18 billion in munis.

Meanwhile, California suffers from more deep-seated problems. It has the highest poverty rate of any state — 19 percent — exacerbated by a shortage of affordable housing.

In response, Newsom is campaigning on priorities including access to preschool for every child and broader family leave policies. While use of the rainy-day fund is strictly governed, he could tap $2 billion in other savings for his plans.

To boost affordable housing, he would expand a version of redevelopment agencies from their current limited use that would enable more building. Cities could set up entities that tap taxes generated by new development for infrastructure projects and issue bonds. “We have specific goals” for these districts, Newsom said during his debate with Cox.

Newsom’s ambitions for future office may dictate how he governs, said Ksenia Koban, a municipal-credit analyst at Payden & Rygel Investment Management. Eighty-year-old Brown didn’t seem to care about making people angry by squirreling away money, she said.

“I don’t know if Newsom would have that degree of comfort,” she said.

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