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California Municipal Bonds: Are the Risks Fully Priced?

In thirty years of reviewing fixed-income allocations for single-family offices, I have seen the same mistake repeated with impressive consistency: clients reach for a familiar yield without asking whether the underlying credit has structurally changed. The tax exemption is real, the retail demand is deep, and the inertia is powerful. California municipal bonds are testing all three of those assumptions right now.

The bull case is well known. California is the world's fourth-largest economy with a GDP exceeding \$4.1 trillion. The double federal-and-state tax exemption translates to a combined marginal rate approaching 54.1% for top-bracket California residents, making even a modest nominal coupon genuinely competitive. Morgan Stanley's municipal team entered 2026 noting that 20-year AA-rated Munis were offering taxable-equivalent yields of just under 7%. On paper, the asset class earns its allocation.

But BlackRock's municipal credit team offered a more candid read in August 2025: strong retail demand has produced spreads that "traditionally do not reflect the fundamental picture." That is institutional language for investors not being paid for the risk they carry. I agree.

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