California Leads Surpluses Making States Into Haven: Bloomberg Muni Credit.

California is moving to pay down debt and boost reserves after an economic rebound left it with the biggest surplus in more than a decade. Hawaii may increase spending on education. Officials in Florida, New York, Minnesota and Wisconsin are considering tax cuts.

The fiscal turnaround for states, a majority of which confronted budget deficits just two years ago, is also paying off for investors in the $3.7 trillion municipal market.

State bonds are proving a haven amid the biggest muni losses since 2008. The extra yield bondholders demand on the governments' general obligations is about 1 percentage point less than the market average, close to the widest advantage since August 2011, Bank of America Merrill Lynch data show.

"The backdrop for states today is much improved versus just a few years ago," said Robert Amodeo, head of munis in New York at Western Asset Management Co., which oversees $28 billion in local debt. "They're growing and they're looking to continue to increase their share of the national economy."

The fiscal rebound is easing pressure on state credit ratings. Moody's Investors Service raised its outlook on the governments to stable from negative in August.

Economy Tailwind

State and local spending began adding to economic growth in the second quarter of last year, a reversal from 2010 to 2012, when it exerted the biggest drag on growth since World War II, Commerce Department figures show. Two years ago, 31 states faced collective deficits of $55 billion, according to the Center on Budget and Policy Priorities in Washington.

Florida, one of the places hit hardest by the real-estate crash, may cut taxes as a result of a $1 billion surplus projected during the next budget year. Michigan anticipates about $1 billion in extra funds. California Governor Jerry Brown has proposed using surplus funds to boost spending, bolster reserves and repay debt used to fill prior shortfalls.

California general obligations maturing in October 2023 traded this week at an average yield of 2.74 percent, or about 0.5 percentage point more than benchmark munis, data compiled by Bloomberg show. That compares with an average gap of 0.8 percentage point since July 30.

Credit Move

Standard & Poor's cited the plans by Brown, a Democrat, when it raised the outlook this week to positive on $75 billion of California debt, a step toward raising its A rating, five levels below the top.

Not all states provide forecasts and some haven't released plans for next fiscal year, which begins

July 1 in most municipalities. Yet at least a dozen states, including Texas, Florida and Michigan, see surpluses after revenue exceeded projections.

States also stand to benefit when individuals file income-tax returns this year, after the stock-market rally that has pushed the S&P 500 index of shares to record highs, said Scott Pattison, executive director of the National Association of State Budget Officers in Washington.

“A lot of states are going to have some pretty decent surpluses,” said Pattison. “I expect there will be some fairly robust revenue surprises coming in.”

Revenue Surprise

States had anticipated that revenue growth would slow this year to 0.8 percent, from 5.7 percent in 2013, according to the budget officers group. In the July-to-September quarter, collections exceeded the projected pace, rising by 6.1 percent, according to the Nelson A. Rockefeller Institute of Government in Albany, New York.

Local governments remain hesitant to borrow after emerging from the longest recession since the 1930s. Muni bond issuance fell 15 percent last year. Nor have governments payrolls returned to peak levels. There were 163,000 fewer state workers in December than in August 2008, Labor Department figures show.

Illinois, Pennsylvania and Maryland are among states still facing deficits.

“States are in a lot better shape than they were,” said Pattison of the budget officers group. “But you still had a lot of states that cut budgets significantly, and they’re not going to have enough money to make up for all the cuts that were made.”

In New York, Governor Andrew Cuomo, a Democrat, this month proposed using a surplus to cut taxes by $2.2 billion, much of which would be used to limit increases on property levies. In Minnesota, Democratic Governor Mark Dayton may cut business taxes as a result of a $1 billion surplus expected there. Florida Governor Rick Scott, a Republican, is using the state surplus to press for a $500 million tax reduction.

Prudency Pause

“Things certainly are better for states, but the question is when things have improved, when revenues have increased, whether or not they remain prudent,” said Konstantine “Dino” Mallas, who helps oversee $20 billion of munis at T. Rowe Price Group Inc. in Baltimore. “That’s always the challenge.”

Issuers nationwide have scheduled about $7 billion of sales in the next 30 days, down from the one-year average of $9.1 billion.

They’re issuing with yields close to a two-month low. Individual investors added money to muni mutual funds this week for the first time since May, Lipper US Fund Flows data show.

The interest rate on AAA 10-year munis is 2.71 percent, the lowest since November and compared with 2.84 percent on similar-maturity Treasuries.

The ratio of the yields, a measure of relative value, is about 95 percent, close to the lowest since May. The smaller the number, the more expensive munis are compared with federal securities.

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