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California Rising Catches Pennsylvania at Bond Crossroad.

California and Pennsylvania are equal in the eyes of Moody's Investors Service. Yet bondholders are rewarding the Western state as it turns years of deficits into a record surplus, while demanding higher yields from Pennsylvania as it fails to tackle pension costs.

The extra interest rate buyers demand to own 10-year California obligations reached 0.25 percentage point this month, the lowest since at least January 2013, when Bloomberg data begin, while 0.33 percentage point is required for comparable-maturity Pennsylvania securities.

The difference is that California lawmakers led by Governor Jerry Brown, buoyed by tax revenue from technology workers, won the state an Aa3 grade last month from Moody's, the fourth-highest mark and the state's best since 2001. Pennsylvania, meanwhile, had its score cut to that level last week by Moody's, which cited one-time revenue fixes in this year's budget. It's the state's lowest grade since 2000.

"California has recovered from a deeper hole and is viewed as more fiscally responsible under Governor Brown," Craig Brothers, an asset manager in Los Angeles at Bel Air Investment Advisors LLC, which oversees \$7 billion, said by e-mail. "Investors view California as an improving credit with strong demand, and Pennsylvania as a stable or weakening credit with less demand."

This is the first time the states have shared a Moody's rating since 2001, when both were graded Aa2, third-highest. California's rank fell two levels by the end of that year to A1. Pennsylvania's remained unchanged for a decade. Connecticut has the same Moody's rank as California and Pennsylvania. New Jersey is graded one level lower, at A1, and Illinois is two steps below that, at A3, for the lowest mark among states.

California, the most-populous state, became more attractive to investors after Brown, a 76-year-old Democrat, persuaded voters to approve temporary increases in income and sales taxes in 2012, yielding an extra \$6 billion a year for schools, said Brothers.

The Golden State's resurgent technology industry has helped make it a stronger bet than Pennsylvania, which is counting on natural gas-yielding shale deposits to revive an economy historically rooted in coal and heavy manufacturing.

Tech Fuel

"The recovery is uneven across California, but in general it's been good, whereas in Pennsylvania the economy post-recession has kind of lagged the past couple of years," said Alan Schankel, a managing director at Janney Montgomery Scott LLC in Philadelphia. "Pennsylvania is more of a rust-belt state, whereas California has more of a tech industry that can help fuel good performance."

California ranked fourth in the Bloomberg Economic Evaluation of States index of economic improvement in the year through March, while Pennsylvania, the sixth-most-populous, placed No. 42.

California's June unemployment rate of 7.4 percent eclipses Pennsylvania's 5.6 percent, according to the Bureau of Labor Statistics. Yet economic trends favor California. Its state gross domestic product increased 2 percent last year, compared with a gain of 0.7 percent in Pennsylvania, the Bureau of Economic Analysis reported.

Net Leader

California is in a "solid and sustainable" recovery led by information services, which includes the Internet and motion pictures, Steve Levy, director of the Center for Continuing Study of the California Economy in Palo Alto, said in a July 18 report.

In the home state of Google Inc. and Twitter Inc., employment in information services grew 5.1 percent in the year that ended in June, making it the fastest-growing part of the economy, he said.

Pennsylvania has trailed the U.S. in most areas, including employment growth, economic output and home construction, JPMorgan Chase & Co. said last month in a report. The state will probably catch up in the second half of the year, led by drilling for gas in shale formations that put the state "on the front lines of new energy developments," according to the report.

Shale Play

Charles Zogby, Pennsylvania's budget secretary, said investors have overreacted to the state's downgrade.

"We may not be growing as fast as some of the other states in the nation, but as the ratings agencies recognize, we've got a fairly diverse and stable economic base," he said by telephone from Harrisburg, the capital. "We have a wealth of resources, especially when you look at the shale play. I find it hard to imagine that the market views Pennsylvania as a more risky place to do business than California."

California's state pension funds are also healthier than Pennsylvania's, with 76 percent of assets needed to cover obligations in 2012, compared with 63.9 percent in Pennsylvania, Morningstar Inc. said in a September report. The U.S. average was 72.4 percent.

In Pennsylvania, lawmakers recessed for the summer without voting on a bill backed by Republican Governor Tom Corbett that would shift some of the burden of funding retirement benefits to new state and school workers. The 65-year-old, who's running for re-election in November, has called the issue the state's "biggest fiscal challenge."

Tax Increases

Standard & Poor's and Fitch Ratings may raise California from its current A rank, sixth-highest, in the next six months, said Burt Mulford, who helps oversee about \$2 billion of municipal bonds at Eagle Asset Management in St. Petersburg, Florida. The companies grade California two steps lower than Moody's.

The state's borrowing costs may sink below yields on top-rated munis as rating increases combine with an inadequate supply of new tax-exempt bonds to sate the wealthiest Californians, he said. California's top earners pay a 13.3 percent state income-tax rate, the highest in the U.S. Pennsylvania's rate is 3.07 percent for all incomes.

"The trend is there — there's going to be another upgrade soon," Mulford said. "Cal is going to start trading through the AAA scale, just because of demand."

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