

# **Bond Case Briefs**

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## **California Zooms Past Russia, Italy and Soon Brazil in Economic Might.**

California is overtaking Brazil as the world's seventh-largest economy, bolstered by rising employment, home values and personal and corporate income, a year after the most-populous state surpassed Russia and Italy.

The Golden State, with an equivalent gross domestic product of \$2.20 trillion in 2013, expanded last year by almost every measure, according to data compiled by Bloomberg. Brazil's gross domestic product, in contrast, declined 1 percent from \$2.25 trillion in the first three quarters of 2014 as its export of raw materials fell.

Governor Jerry Brown, 76, sworn in this month to an unprecedented fourth term, is presiding over the turnaround as he steers away from persistent deficits and fiscal turmoil that prompted Republican presidential candidate Mitt Romney in 2012 to compare California to Greece, which has about a 10th of its GDP. California-based companies from Apple Inc. to Walt Disney Co. handed investors a total return of 119 percent since January 2011, when Brown returned to the governor's office, compared with 96 percent for the Standard & Poor's 500.

"It's the diversity of the California business environment, from movies to the Internet to agriculture — the incredible array of businesses that make up the state," Brown said yesterday in an interview at his office in Oakland, where he was mayor from 1999 to 2007. "Certainly getting our finances in line as a state is also helpful: the new investments in our schools; solid universities; investments in water and energy. All this gives security and keeps California very much in the forefront of investment, change, cultural adaptation and leadership."

### **Sustained Momentum**

Brown's economy has sustained its momentum since 2013, when the value of goods and services produced in the state topped that of Russia and Italy to vault California to No. 8 in the world. California grew an average of 4.1 percent annually during the first three years of Brown's most recent term.

Economists in Brazil, with a population five times bigger than California's 38.3 million, cut their growth estimate and raised their inflation forecast for this year on Jan. 12, as the central bank raises rates in the world's second-biggest emerging market. Its economy grew 0.1 percent in the third quarter over the three previous months, after contracting 0.6 percent in the second quarter.

"Resource-rich nations are traditionally subject to boom and bust," Brown said. "We're not just dependent on one particular industry or resource."

### **Renewable Energy**

Brown, in his inaugural speech on Jan. 5, said the California economy can expand even as the state grows more aggressive in requiring the use of renewable energy sources and reducing the use of

gasoline.

"We have to prove to the world that you can move forward with progressive and forward-thinking climate change policies while growing the economy simultaneously," Kevin De Leon, a Democrat and state senate president pro tem, said yesterday in an interview in Sacramento. "They're mutually compatible and inclusive as opposed to exclusive."

Brown's policies, for the most part, are proving beneficial to the long-term economic health of California, said Chris Thornberg, principal at Beacon Economics LLC, a Los Angeles-based research company. Thornberg credited larger forces, though, from Federal Reserve policy to the purging of bad loans from the real-estate market for the state's recovery.

### **'Better Job'**

"From an investor standpoint, I don't think anybody could have done a better job," said Michael E. Johnson, managing partner at Gurtin Fixed Income Management in Solana Beach, California.

California's ascendance comes as the World Bank cut its forecast for global growth this year, with the improving U.S. economy and lower fuel prices failing to offset disappointment elsewhere in the world.

"The global economy today is much larger than what it used to be, so it's a case of a larger train being pulled by a single engine, the American one," World Bank Chief Economist Kaushik Basu told reporters on a Jan. 13 conference call. "This does not make for a rosy outlook for the world."

California leads U.S. states in agriculture, technology and manufacturing revenue growth, Bloomberg data show. It's home to more companies on the S&P 500 than any other state. The state's job growth outpaced the nation's in the first nine months of last year. California's non-farm employment of 15.7 million people is at an all-time high.

### **Poverty Rate**

Challenges remain. While employment rebounded last June to levels from before the 18-month recession that ended in 2009, its jobless rate of 7.2 percent as of November was tied with Mississippi for the second-highest among U.S. states.

Almost a quarter of Californians live in poverty, the highest rate in the nation, according to the U.S. Census Bureau. Spending on welfare remains lower than before the recession began.

"We've brought our unemployment rate down rather quickly and we've recovered the jobs deficit that we incurred during the recession, which in percentage terms was bigger than the nation's," said Robert Kleinhenz, the chief economist for the Los Angeles County Economic Development Corp. "It dug itself into a deeper hole but it did manage, through faster growth, to recover almost as quickly."

California has rebounded from when Romney, the former governor of Massachusetts, dismissed the state as a failed economy as it grappled with the prospects of tax increases and budget cuts.

### **'Like Greece'**

"Entrepreneurs and business people around the world and here at home think that at some point America is going to become like Greece or like Spain or Italy, or like California — just kidding about that one, in some ways," Romney said, to laughter from his audience.

Like California, the city of Oakland, of which Brown was mayor for two terms, has experienced an economic revival.

"The proximity of San Francisco and being located in the Bay area" are the pivotal factors behind Oakland's resurgence, Brown said. "There is a dynamic interplay. Oakland is closer to San Francisco than San Francisco is to itself. West Oakland is closer to the financial district and even south of Market than most of San Francisco. I did push condo development and responsible policing to keep the crime down."

The new Oakland mayor, Libby Schaaf, was a former Brown aide and City Council member who emerged as frontrunner after winning the governor's endorsement in October.

## **More Bullish**

Analysts are more bullish on California-based businesses than on U.S. companies, as measured by the Russell 3000 index, Bloomberg data show. Companies based in the state will provide a 15 percent return to investors in the coming year, compared with 12 percent for the index.

To those who assert that California's tax and regulatory structure make it a hostile place to do business, Brown offers an anecdote: He tells a story about a Silicon Valley investor he met at a cocktail party who started and sold three technology-related businesses.

The man told the governor he's in California because the state has "more smart people with money and more people who know how to spend that money by way of tech companies and ventures that are constantly sprouting up."

The cost of protecting bonds of California from default tumbled the most among all the states in the four years ended Dec. 31. Credit-default swaps, which investors use to hedge against losses or to speculate on creditworthiness, declined 201 basis points to 104 basis points, Bloomberg data show.

## **Investor Confidence**

Credit swaps, which typically decline as investor confidence improves and rise as it deteriorates, pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals \$1,000 annually on a contract protecting \$10 million of debt.

"That huge deficit was a shock to the political sensibility," Brown said. "I was able, in that context, to win substantial cuts on the part of government spending. I was also able to win approval of Proposition 30 to inject more revenue into the economy. All of that together brought us a place of more stability."

While final figures for 2014 for the California economy won't be available until June, projections in Brown's proposed state budget show the gains.

Per-capita annual income in California was estimated to have increased by \$1,700 to \$50,338 in 2014, according to state data. California home prices climbed an average of 12 percent last year through Sept. 30.

## **'Growing Faster'**

"California is growing faster than the U.S. economy, which is a bright spot in the global economic situation," said Sung Won Sohn, a professor at California State University-Channel Islands in Camarillo who was chief economist at Wells Fargo & Co. "California is always more volatile than the

U.S. We tend to go down more rapidly and we tend to rise more rapidly.”

Brown’s Jan. 9 budget proposes spending a record \$165 billion. Temporary sales and income tax increases that he championed in 2012, combined with surging capital gains revenue tied to stock market gains, have left the state with a \$5 billion surplus in the fiscal year that begins in July. The governor is seeking to store much of that surplus in reserves to cushion against economic downturns.

California-based technology companies brought in \$692 billion in revenue in the past 12 months, about half the industry’s sales across the U.S. The value of manufacturing in California climbed 8 percent to \$204 billion in 2012, compared with a 7.4 percent increase in Texas to \$176 billion.

## **California Agriculture**

Agriculture in California produced \$21.4 billion in revenue in 2012, three times more than the \$6.8 billion in second-ranked Iowa. The number of companies in California that rank in the top 500 in the world in terms of market capitalization rose almost 48 percent since 2009.

High-technology jobs in the business and professional services sector in California were forecast to grow to 15.7 percent of the economy in 2014, up from 15.4 percent a year earlier.

“I’ve found that people get very stuck in what is,” Brown said. “I very much like tradition, but you have to be able to change and disrupt while balancing tradition. The continuity and the change blending together is your creative task.”

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