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California's Shrinking Bond Costs Dissuade Buyers: Muni Credit.

(Bloomberg) — California's standing on Wall Street is the strongest since the recession, with revenue surging and cash tucked away for a rainy day. For some investors, the fiscal gains have only diminished the appeal of its debt.

Since Governor Jerry Brown took office in 2011, California has swung to a \$5 billion budget surplus from a \$25 billion shortfall. The Democrat won approval of higher taxes and a new reserve fund. Fitch Ratings' upgrade last week gave the most-populous state its highest marks from the three biggest rating companies since at least 2009.

As the state begins selling \$1.9 billion of general-obligation bonds Tuesday, a rally in its securities has shrunk their extra yield relative to top-rated municipal debt close to the skimpiest since 2007, according to data compiled by Bloomberg.

"I wouldn't expect the yields to be high enough for us, but we will certainly take a look," said Michael Johnson, managing partner at Gurtin Fixed Income Management, which oversees \$9.5 billion in Solana Beach, California.

Day One

California's offering will include \$1.1 billion for refinancing and \$790 million for projects such as water and school improvements, according to offering documents. Individual investors bid the first day and institutional buyers such as mutual funds submit orders Wednesday.

In initial marketing Tuesday, the state offered a preliminary yield of 2.35 percent on 10-year maturities, according to a person with knowledge of the sale who requested anonymity before pricing is complete. That would be about 0.25 percentage point above Bloomberg's index for tax-free benchmark debt.

Investors demanded as little as 0.17 percentage point of extra yield on 10-year California obligations last month, data compiled by Bloomberg show. That's down from a peak of about 1.7 percentage points in 2009, when the state resorted to IOUs to pay bills. In 2006 and 2007, before deficits soared amid the recession, the gap was as little as about 0.1 percentage point.

California munis earned almost 11 percent last year, compared with 9.3 percent for the entire municipal market, S&P Dow Jones Indices show.

The gains have left the debt with spreads resembling those of higher-rated states, such as Massachusetts and Ohio. Connecticut and Pennsylvania, with the same Aa3 Moody's Investors Service grade as California, trade at spreads of 0.3 percentage point or steeper. Given California's position as the largest debtor in the U.S. municipal market, some investors say they need to buy it no matter what.

Index Link

"If you want to have a portfolio that is somewhat linked to the indexes, you have to have it," said Paul Mansour, head of muni research at Conning, which oversees about \$11 billion in local-government debt in Hartford. "The question is do you go crazy on it or do you go with a more moderate level, and I think a more moderate level is our view."

Brown, 76, in January proposed a record \$113 billion spending plan for the year beginning July 1 that devotes most of a \$5 billion surplus to schools, reserves and paying down debt.

In November, after voters agreed to bolster a rainy-day fund for fiscal emergencies, Standard & Poor's boosted California to A+, its fifth-highest mark and the state's best since 2009 from the company. Fitch on Feb. 25 raised California to the same level, also the strongest since 2009, citing a "disciplined approach to achieving and maintaining structural balance in recent budgets."

Moody's Aa3 assessment is the fourth-highest level and the best mark since 2001.

California Treasurer John Chiang, who took office in January, said the Fitch upgrade "is both a validation of California's recently displayed fiscal discipline, as well as a stern warning against returning to business-as-usual."

California's rating sank to the lowest among states in 2009 as lawmakers were locked in a stalemate over how to eliminate a \$42 billion shortfall. The state dealt with more than \$100 billion of cumulative deficits from 2000 through 2010.

"California has had a dramatic change" in areas such as revenue growth and cost reductions, Mansour said. "You are still getting a decent spread in California."

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