Bond Case Briefs

Municipal Finance Law Since 1971

California Rainy Day Fund Yields Results in Bond-Market Recovery.

California is once again the Golden State in the eyes of municipal-debt investors.

Bonds of the state, which was so strapped after the recession that it took to issuing IOUs and drew comparisons to Greece, are the best performers in the $3.6 trillion tax-exempt market this year after the obligations of Michigan. Investors are even willing to accept yields lower than benchmark indexes on the state's short-maturity debt, data compiled by Bloomberg show.

California plans to take advantage of the renewed faith in its finances by selling $1.9 billion in general obligations this week in the first offering of the securities since Standard & Poor's raised the state's credit rating to its highest level in 14 years. California's economy is expanding faster than the nation's, in part because of the technology-industry boom.

"The state of California has done a very nice job as far as improving its fiscal situation," said Greg Kaplan, director of fixed income in San Francisco at City National Bank's Rochdale unit, which manages $4.4 billion in munis. "Five years ago, people didn't want that paper. That fear is gone."

In July, S&P lifted the state's rating to AA-, its fourth-highest level, and pointed to passage of a budget that directed money to a rainy-day fund approved by voters in November. The fund, which requires the state to save a portion of capital-gains taxes, helps cushion the state when receipts fall, the company said.

Credit Environment

"It was important to see them enact a budget that represented an extension of their recent approach to their fiscal policy, which has been to emphasize structural alignment between the ongoing revenues and recurring expenditures," Gabriel Petek, a San Francisco-based S&P analyst, said Monday.

Investors have also liked how California under Governor Jerry Brown has notched budget surpluses after more than $100 billion of cumulative deficits from 2000 through 2010.

"Governor Brown has put the fiscal house in order," said Ben Woo, senior municipal analyst at Columbia Threadneedle Investments, which manages about $30 billion in local debt. "Compared to the chaotic political environment we're seeing in New Jersey and Illinois, California is a much better credit environment than some other states."

Penalty Declines

Investors are demanding about 0.18 percentage point over top-rated debt to own 10-year California securities, close to the 0.17 percentage point low since 2013, according to data compiled by Bloomberg. That's down from a peak of about 1.7 percentage points in 2009, when the state resorted to IOUs to pay bills.

That’s also better than the 0.52 percentage point for debt issued by Pennsylvania, which has the same investment-grade ratings from S&P and Moody’s Investors Service.

If mutual-fund flows remain consistent, it’s a “pretty easy case to make” that California spreads can go to 0.1 percentage point this year, Kaplan said.

That level was seen in 2006 and 2007, before deficits for the nation’s most indebted state soared amid the recession and sparked comparisons to Greece, which recently received its third bailout since 2010 from European authorities to repay creditors.

Capital Projects

California is selling bonds mostly to refinance debt and to fund capital projects such as roads and public buildings.

“We have to take advantage of our recent credit upgrades, and I encourage individual and institutional investors to get behind California and help us make this sale a success,” State Treasurer John Chiang said in a statement.

On Tuesday, when individual investors had a chance to order the securities, 10-year bonds were being marketed at a yield of 2.38 percent, according to a person familiar with the sale who requested anonymity because pricing wasn’t final. That compares with 2.21 percent for top-rated munis. Final prices will be set Wednesday.

The size of the deal might “take some digestion” and may prevent the state from testing new lows for yields, said Woo, the analyst at Columbia Threadneedle.

Adrian Van Poppel, who helps run a California fund for Wells Capital Management in San Francisco, said he would want risk premiums above those seen on existing bonds before buying.

“It’ll just come down to pricing for us,” he said. “You’re not getting much” in extra yield for debt maturing under five years.

Investors are demanding 0.57 percent to own California two-year bonds, less than the 0.6 percent for benchmark munis, according to data compiled by Bloomberg.

“We’ll definitely be following it,” Van Poppel said. “They’ve been moving in the right direction.”

Bloomberg

Romy Varghese

August 24, 2015