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California Tech Boom Lures Muni-Bond Buyers as Deficit Era Ends.

Bond investors are betting that a resurgent tech-fueled boom in the Golden State isn't just California dreaming.

The state, which faced ballooning budget shortfalls after the housing crash, is selling about $961 million in general-obligation bonds next week, its last sale of the securities this year. California debt is outperforming amid a rally in the municipal market as the state's finances benefit from the fast-growing economy.

"If you invest in California, you're betting that their economic improvement is likely to continue," said Paul Mansour, head of municipal research at Hartford, Connecticut-based Conning, which holds California bonds among its $11 billion of tax-exempt debt. "I'm reasonably optimistic that we've got another few years to go of growing tax revenues and building up reserves."

Fueled by Silicon Valley's technology industry and a real-estate market revival, California's economy has outpaced the nation's since 2012. Along with tax increases backed by Governor Jerry Brown, that has halted the chronic shortfalls that once plagued the state, allowing it to pay off debt and add to its savings ahead of the next slowdown.

Wall Street has rewarded the turnaround. In July, Standard & Poor's lifted the state's grade to AA-, the highest California has had in 14 years. Bonds from the state have returned 2.47 percent this year, about half a percentage point more than the overall muni market, according to S&P Dow Jones Indices.

California has benefited from "increased revenues and some controls on spending in a time when they really needed it," said Regina Shafer, senior portfolio manager of tax-exempt investments at USAA Investment Management, which holds $9.9 billion in munis, including California debt. "That bodes very well for the state and for the future."

California's economy should continue to expand faster than the country's over the next couple of years because of the technology industry and growth in residential and commercial construction, economists at Wells Fargo Securities said in a report this month.

The home to companies including Alphabet Inc., Apple Inc. and Facebook Inc. has also been benefiting from stock-price gains pocketed by its wealthiest residents: In May, Brown's administration forecast that its residents will reap $109 billion in capital gains next year, up from $79 billion in 2013. Such income has driven a jump in the state's revenue.

The new bonds, some of which will refinance higher-cost debt, will be sold in an auction among underwriters Tuesday. All but $106 million of them are exempt from state and federal income taxes.

The demand for such securities has been heightened by a ballot measure passed in 2012, which boosted income taxes on the highest-earning households through 2018. Labor unions are among those pushing to make the increase permanent.

“With their state personal-income tax at higher levels, it certainly makes a California bond more compelling,” said USAA’s Shafer.

The difference between the yield on California bonds and top-rated securities has widened since the beginning of the year, when it dropped to the lowest since at least 2013, according to data compiled by Bloomberg. California 10-year bonds yield 2.36 percent, about 0.3 percentage point more than AAA rated securities. That gap was as little as 0.17 percentage point in January, one-fourth of what it was at the June 2013 peak.

Even with the increase, California’s yields are still lower than some comparable states — making the securities expensive in comparison. Ten-year securities issued by Pennsylvania, which has the same investment-grade ratings from S&P and Moody’s Investors Service, yield 0.54 percentage point more than top-rated debt. For Connecticut, whose S&P rating is one step higher, that gap is 0.46 percentage point.
Mansour at Conning, which might purchase the new bonds, said

California’s growing reserves and lower debt load may lead to another credit-rating increase.
“There is room for credit improvement in the coming year,” Mansour said.

An upgrade isn’t being signaled by Moody’s, S&P or Fitch, which have stable outlooks, indicating no changes are imminent.

Moody’s said in a report this month that the state has “significantly less flexibility” than others in budgeting and raising funds. Its revenue is volatile because it draws a large share of taxes from wealthy residents whose incomes are tied closely to the stock market, which has slipped from record highs.
Investors should weigh whether California’s economic pace will continue and if Brown, a Democrat, can resist pressure to spend the windfall, said Rob Amodeo, head of municipals for Western Asset Management Co., which has $25 billion of munis under management and may buy some of the new debt.

“The governor has done a good job in not permitting austerity fatigue to settle into their budget,” he said.

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by Romy Varghese

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