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California Bonds Lose Allure as AIG Stake Cut by Most Since 2010.

The Golden State is losing its luster to municipal-bond buyers such as American International Group Inc. and Principal Global Investors.

AIG's California debt holdings were reduced by \$764 million, or 17 percent, to \$3.86 billion in the three months ended Sept. 30, the steepest quarterly decline since at least 2010, company filings show. As a result, the state makes up just 14 percent of the New York-based insurer's \$27.5 billion municipal portfolio, the smallest share in two years.

Following a five-year run when California bonds outperformed the \$3.7 trillion municipal market, investors are starting to retreat: They're demanding the highest yields in 16 months to own the state's 10-year securities instead of benchmark debt. The shift is threatening the rally ignited by a wave of good financial news that's led to eight upgrades to its credit rating since the end of the recession.

"We're pretty much at the top" of the California rally, said Mark Wuensch, senior fixed-income analyst in New York at Principal Global Investors, which manages \$5.3 billion in munis as the asset-management arm of Principal Financial Group. It decided against buying in California's most recent sale. "It can't continue to get better than this. It's just not enough spread for institutions and even retail to get involved."

California, the most-indebted U.S. state, with about \$76 billion of general-obligation bonds, has turned its finances around since the end of the recession in 2009, thanks to the growth of technology industry, a real estate rebound and Governor Jerry Brown's successful push for a tax increase on the highest earners.

The influx of revenue has allowed the state to put an end to once-chronic deficits, pay off debt and save ahead of the next slowdown, with California projecting that its rainy-day fund will more than double this fiscal year to \$3.5 billion. That's in stark contrast to states like Illinois, New Jersey and Pennsylvania, which have been besieged by rating cuts as they struggle to balance their budgets.

In a sign of the market's favor, California bonds traded near parity with those from AAA rated Texas as recently as August after Standard & Poor's upgraded the Golden State to AA-, the fourth-highest rank.

Moody's Investors Service raised it in June 2014 to an equivalent Aa3, the highest since 2001. When California sold \$972 million of debt on Oct. 20, general obligations due in 10 years were priced to yield 2.14 percent, compared with 2.06 percent for an index of AAA munis, according to data compiled by Bloomberg.

The tide has turned, with investors starting to demand higher yields relative to top-rated securities. The yield difference between 10-year California bonds and AAA munis is 0.32 percentage point, near the highest since July 2014 and up from as little as 0.17 percentage point at the start of the year,

Bloomberg data show.

Jennifer Hendricks Sullivan, a spokeswoman for AIG, declined to comment on why the company reduced its California bond holdings. Overall, the company trimmed \$116 million from its municipal exposure during the quarter.

Too Expensive

Principal Global Investors didn't buy bonds in California's October offering because they were too expensive, said Wuensch, the analyst. The Des Moines, Iowa-based company isn't seeking additional state debt to buy, he said, though it also isn't selling what it already owns.

Other money managers are betting the rally will resume because the recent rise in yields will draw investors, who are seeking higher returns as the market's rates hover near five-decade lows.

"The credit story will be stable to positive, the economy is still chugging along, and the revenue growth will be there," said Paul Brennan, a portfolio manager in Chicago at Nuveen Asset Management, which oversees about \$100 billion of munis and bought some bonds in the October sale.

"Conditions are pretty favorable for potentially more tightening" because California isn't scheduled to issue more general obligations in 2015, Brennan said.

With the state gaining financial momentum, its bond yields have held well below two like-rated states, Connecticut and Pennsylvania, leaving California debt expensive in comparison. Connecticut's 30-year securities yield 0.59 percentage points more than top-rated debt, while Pennsylvania's are 0.64 percentage point higher. That's more than twice the premium demanded of California.

The upgrades that have sustained California's rally may also be subsiding: Moody's, S&P and Fitch Ratings all have stable outlooks on the state, indicating no changes are imminent.

"We like the story" of its improved financial situation, Wuensch said. But when it comes to the value of California bonds, "how much richer can they get?"

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