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California's Recovery Loses Luster as Tax Increases Set to Lapse.

California's three-year boom run is showing signs of fatigue.

Shaking off recession-era comparisons to Greece, the most-populous U.S. state rebounded with surpluses and an economy fueled by the fast-growing technology industry, which garnered it eight bond-rating upgrades.

Governor Jerry Brown is now forecasting that revenue growth is slowing along with the economy after April's income-tax collections lagged expectations, in part because of the sputtering stock market. Even if voters in November decide to keep a temporary income-tax increase from ending — a measure that Brown hasn't endorsed — the budget would "barely be balanced," his administration said this month.

"We see the state at somewhat of a crossroad," said Bernhard Fischer, senior fixed-income analyst at Principal Global Investors, which holds $6.2 billion of municipal bonds, including those issued by California. "They need to prepare to address the expiring tax increases and prepare for spending cuts. Maintaining balanced budgets is critical for the long-term credit of the state."

Following the housing-market crash, California dealt with budget shortfalls so severe it was forced to issue IOUs in 2009 when lawmakers couldn't agree on a fix. The tax increase, approved on the November 2012 ballot, helped California reverse its fiscal fortunes, leaving officials in 2013 debating how to use a surplus. As it arrived, Brown paid down debt and socked money away to use the next time the economy tumbles into a recession.

The shift has been lauded on Wall Street. S&P Global Ratings raised California last year to AA-, the fourth-highest grade and the best for the state since 2000. Moody's Investors Service rates it a comparable Aa3, its most positive assessment in 15 years. California's 10-year bonds yield about 1.85 percent, or 0.23 percentage point more than top-rated securities, according to data compiled by Bloomberg. That gap is down from as much as 0.67 percentage point three years ago.

California's job gains are expected to slow alongside the national economy, with the U.S. gross domestic product projected to grow by 1.8 percent this year, down from 2.4 percent in 2015, according to the median forecast of economists surveyed by Bloomberg.

In anticipation, Brown's administration this month reduced its revenue estimate for the year that begins in July by $1.9 billion, citing weaker-than-expected receipts of income and sales taxes since January. Even so, the governor's budget would still raise spending by 5.7 percent and nearly double the amount in its rainy-day fund to $6.7 billion. The plan is awaiting approval from the legislature.

California's outlook is darkened by the scheduled end of tax increases that were approved in 2012. The additional quarter-percent sales tax expires at the end of this year, while a higher income tax on the wealthiest will cease in 2018. Labor unions, including those representing teachers, are backing an initiative for the November ballot that would continue the income-tax hikes through 2030.

Although Brown hasn't expressed support for the measure, he projects that the loss of the taxes will leave the state spending $1.7 billion more than it brings in during the 2019 budget, a shortfall that will grow to $4 billion the following year.

That actually may be good news for bond buyers who want California securities but are dissuaded by the low yields relative to other securities.

"From a bond buyer's perspective, you'd like to see some operating deficits or more stress on the budget just because spreads would widen out, and assuming that the economy is fairly strong, you can withstand tax increases and potentials for cuts in expenditures," said Howard Cure, head of municipal research in New York at Evercore Wealth Management, which oversees $6.3 billion of local debt.

The volatility in the stock market also poses risks. California is highly susceptible to equity-market swings because the top 1 percent of earners — who tend to own shares — accounted for nearly half of its personal income-tax collections in 2014.

While the state benefited from rising equities since 2012, "in a sustained market correction – which is inherently unpredictable – the dynamic would work in reverse, making state tax revenues susceptible to a steeper drop-off," S&P analysts led by Gabriel Petek wrote in a May 17 report.

The state is better prepared for a recession than it was before the last one began at the end of 2007, said Rob Amodeo, head of municipals in New York for Western Asset Management Co., which holds $25 billion of the securities, including California's. Still, he pointed to an April Moody's report that showed that out of 20 states, California was among the most vulnerable.

"The credit is plateauing," Amodeo said.

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