Investment Insights

State of the State: California

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Overview

California has taken steps to shake off its reputation as a volatile credit that is highly vulnerable to economic downturns and lacks the political will to solidify its credit standing.

California's relative economic strength, solid financial market performance, voter-approved procedures providing increased budget flexibility, and continued budget discipline helped the state build a large fiscal cushion going into the corona virus (COVID-19) pandemic. Its ability to maintain robust budget reserves should also provide a cushion against potential downturns in the national economy.

In this piece, we provide an economic and fiscal update of California and highlight a revenue bond that we find attractive in the state.

State overview

Invesco's view

California's tax structure is dependent on a small group of high-income taxpayers, who have helped fill the state's coffers with personal income taxes fueled by economic growth and strong financial market performance. California voters also helped generate more revenues from those high-income taxpayers by approving temporary income tax rates. Including surcharges for incomes above $1 million, the combined top income tax rate of 13.3% has been levied since 2012.[1] To date, state leaders have exercised caution with the growing pot of revenues, choosing to build up reserves, pay down liabilities, and limit the amount of new ongoing expenditures. Again, California voters helped the state manage its resources first by authorizing more flexibility in the budget adoption process, and later by creating more budget reserves with tax revenues generated from excess capital gains taxes.

Going into the pandemic, California had built a large cash cushion and sources of liquidity that mitigated the expected declines in tax revenues. The state also cut and deferred expenses to maintain fiscal flexibility.

California's fiscal condition has continued to outpace expectations. Based on budget documents from the State Department of Finance, fiscal year (FY) 2021 general fund reserves had been projected to decline to about $10.7 billion, or 8.0% of budgeted expenditures. While tax revenues had been expected to decline, they skyrocketed to end the fiscal year over 43% higher than budget projections. Budget reserves climbed to more than $52 billion, or 32.4% of adjusted expenditures.[2]

The trend of conservative budgeting and the tax revenue windfall helped the state maintain fiscal reserves again in FY 2022. Reserves had been projected to decline to $25.2 billion, but ended the year at $46.7 billion, or 19% of expenditures. California's ability to maintain a robust level of budget reserves was driven by the continued growth of tax revenues, which finished the year nearly 30% higher than budget projections.[3] California also augmented general fund resources by transferring $9.2 billion of the state's $27 billion allocation of federal funds from the American Rescue Plan in FY 2022.[4]

California appears to have weathered the impacts of the pandemic but there is still uncertainty over its future financial performance given the slowdown in the economy and volatility in the financial markets. Although the state's high level of budget reserves should help mitigate potential hurdles, it still faces headwinds in FY 2023 and beyond. While reserves were estimated to decline in the FY 2023 state budget, the projected level of reserves would still provide a solid cushion of nearly 16% of estimated expenditures. However, the independent Legislative Analyst's Office (LAO) recently estimated that the budget reserves would fall short of those in the current budget. The LAO now estimates that FY 2023 budget reserves will be about 9% of expenditures, or roughly $17 billion less than the amount in the enacted budget.[5]

1. Official statement for state of California general obligation bonds, Sept. 2, 2020.
2. California Department of Finance, Enacted Budget Summary 2020-21, dated June 26, 2020, and Enacted Budget Summary 2022-23, dated June 27, 2022.
3. California Department of Finance, Enacted Budget Summary 2021-22, dated June 28, 2021, and Enacted Budget Summary 2022-23, dated June 27, 2022.
4. California Department of Finance, Governor's Budget Summary 2022-23, January 2022.
5. California Legislative Analyst's Office, California's Fiscal Outlook, November 2022.

Issuer Spotlight: California State General Obligation Bond Rating Update

Moody's: Aa2/Stable Outlook

Moody's has rated the state of California's general obligation bonds Aa2 since its last upgrade in October 2019. Moody's last affirmed its rating and stable outlook in October 2022. Moody's expects the state's large economy and wealth levels will be able to generate revenues sufficient to maintain structurally balanced budgets even during periods of moderate shocks to state revenues during periods of economic weakness.

Standard & Poor's: AA-/Positive Outlook

Standard & Poor's (S&P) has maintained a rating of AA- on the state of California's general obligation bonds since its last upgrade in July 2015. In September 2021, S&P revised its outlook on the credits to positive from stable, and the company affirmed both the rating and positive outlook in October 2022. S&P maintained its positive outlook based on estimates of structural budget balance and high levels of reserves, even if current levels of tax receipts and federal aid fall back to historic trends.

Fitch: AA/Stable Outlook

Fitch has rated the state of California's general obligation bonds AA since its last upgrade in August 2019 and affirmed its rating and stable outlook in October 2022. Fitch's stable outlook reflects the state's large and diverse economy, which supports strong revenue growth prospects, the ability to manage expenditures, and moderate levels of debt and pension liabilities. The state's strong fiscal management has helped build reserves that mitigate impacts from economic and revenue cycles.

Fiscal Update: General Fund Revenues

California General Fund Revenues* ($Millions)	Fiscal Year 2022	% of Total
Personal Income Tax Revenues	136,497	5.86%
Sales and Use Tax Revenues	32,750	14.1%
Corporate Tax Revenues	46,395	19.9%
Other Revenues	17,096	7.3%
Total General Fund Revenues	232,738	100.0%

* Excludes transfers

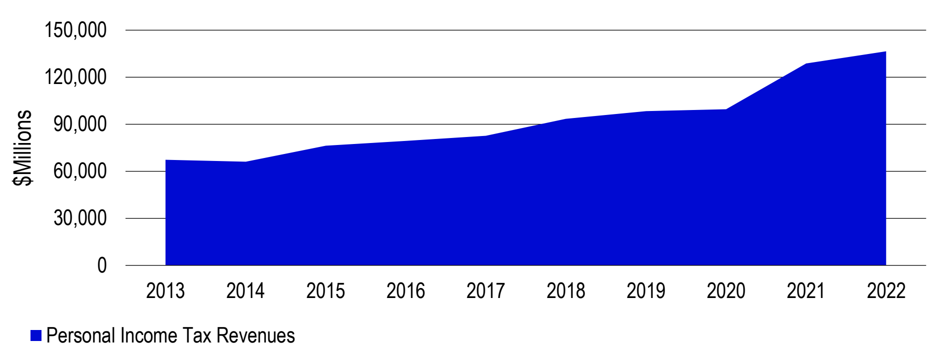
Source: California Department of Finance, June 2022.

The decline in FY 2023 reserves in the LAO report is driven by estimates that personal income taxes will be about 9% lower than budget projections. While income tax revenues through October 31 were above fiscal-year-to-date projections,[6] those taxes may face headwinds later in the year due to volatile financial market performance. The LAO has indicated that the decline in tax revenues could cause the state to face a budget deficit in FY 2024.[7] While the deficit could force California to deplete its reserves in FY 2024, we expect that budget adjustments will be made to mitigate the impact from lower tax receipts.

Personal income tax revenue has been a driver of revenue growth in California. Prior to the pandemic, the state experienced a long period of economic expansion, robust growth in financial markets, and temporary tax increases, which fueled tax growth that has extended into the current year. As shown in the chart below, personal income taxes more than doubled from $67.3 billion in FY 2013 to $136.5 billion in FY 2022. [8]

Income tax receipts have been driven by a state tax structure that is dependent on high-income taxpayers and sources of income that create the potential for revenue volatility. Personal income taxes grew to nearly 69% of general fund revenues in FY 2021.[9] While the level of growth of tax receipts was initially hampered by the onset of the COVID-19 pandemic, the actual impact to tax receipts was mitigated by income taxes generated from high-wage taxpayers and capital gains.

General Fund Income Tax Revenues



Source: California State Controller though FY 2019; California Department of Finance FY 2020 through FY 2022

Recent budget friendly legislation and voter initiatives have increased fiscal flexibility to some degree, but the state tax structure also increases the potential for revenue volatility. The state budget process lacks fiscal flexibility due to school funding formulas and super-majority requirements to raise taxes. Future economic growth could also be hampered by high costs of living and business expenses. We note that each of the rating agencies maintained their high-grade ratings and stable or positive outlooks since the onset of the pandemic. Despite the recent trend of strong economic and revenue growth, however, ratings have been constrained relative to other states due to the California's fiscal flexibility headwinds.

6. California State Controller, Statement of General Fund Cash Receipts and Disbursements, October 2022.
7. California Legislative Analyst's Office, California Fiscal Outlook, November 2022.
8. California State Controller for FY '13 through FY '19, California Department of Finance since FY '20.
9. Based on updated revenue reports in California Department of Finance, Enacted Budget Summary 2022-23, dated June 27,2022.

General Fund Expenditures ($Millions)

Excludes Transfers

	FY 2022 Amount	% of Total
Education	102,058	42.0%
Health & Human Services	53,092	21.9%
Public Safety/Corrections	14,401	5.9%
Debt Service*	4,518	1.9%
Other Expenses	68,875	28.4%
Total Expenditures	242,944	100.0%

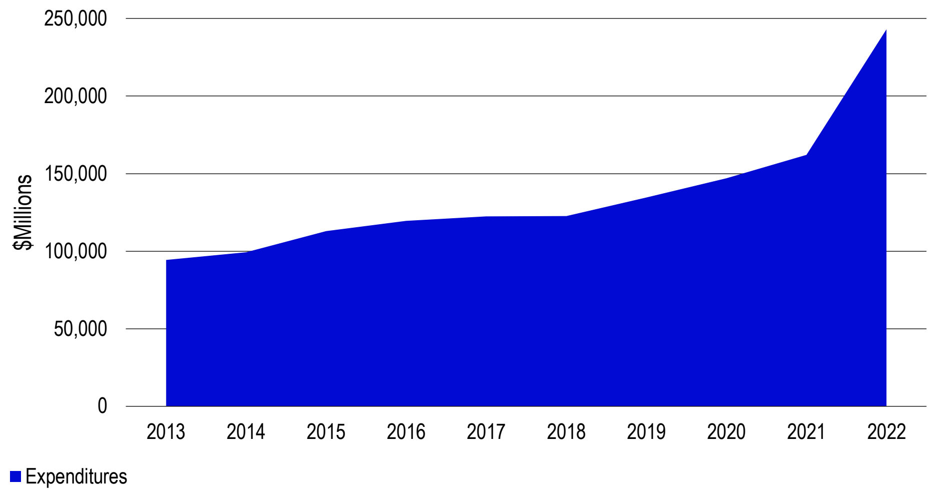
Source: California Department of Finance, June 2022.
*Source: California State Controller, July 2022.

Fiscal Update: General Fund Expenditures

The level of annual state general fund expenditures is driven by education funding, the largest line item in the state budget. In FY 2022, education represented 42.0% of state general fund expenditures.[10] Under California statutes, increased general fund revenue growth will trigger increased spending on education. As revenues grew above original projections in FY 2022, budgeted expenditures were revised, and K-12 school funding constituted over 36% of expenditures.[10]

The state's second funding priority is debt service. Although California is the largest issuer of municipal bonds, debt service represented only 1.9% of general fund expenditures in FY 2022.[10]

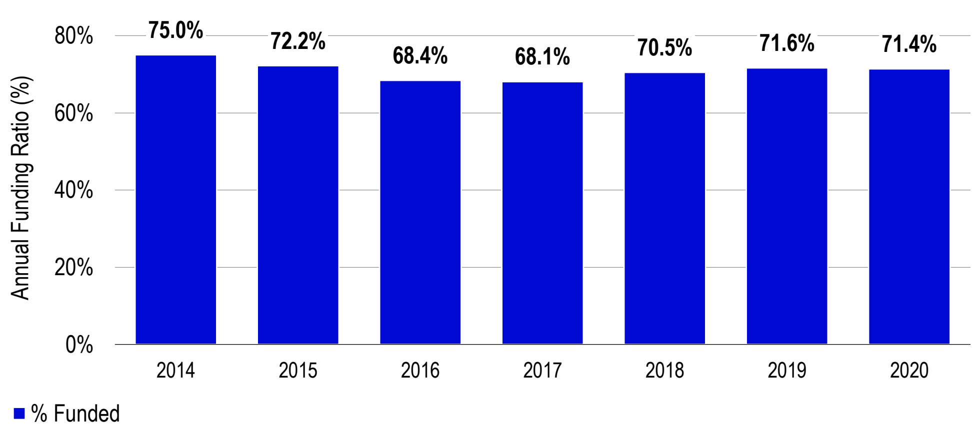
General Fund Expenditures



Source: California State Controller though FY 2019; California Department of Finance FY 2020-2022

California Pension Funding

The state maintains two major defined pension plans, the California Public Employees' Retirement System (CalPERS) and the California Teachers' Retirement System (CalSTRS). The combined funding ratio of both retirement systems decreased to 71.4% as of June 30, 2020. California has been making extra pension contributions from excess capital gains taxes, and the FY 2023 budget includes a $3.4 billion supplemental contribution.[11] Future pension funding levels could be impacted by reductions in supplemental contributions and lower investment returns.



Source: Standard & Poor's, as of March 31, 2022.

10. California Department of Finance, enacted Budget Summary 2022-23, dated June 27, 2022.
11. Standard & Poor's, August 11, 2022.

CA vs Us Personal Income Growth (Annual Increase)

	CA % Change	US % Change	CA % of US Personal Income
2015	6.4%	3.9%	111.9%
2016	3.7%	1.8%	114.0%
2017	4.0%	3.9%	114.1%
2018	4.6%	4.3%	114.4%
2019	4.6%	3.6%	115.4%
2020	8.8%	6.2%	118.2%
2021	8.4%	7.3%	119.4%

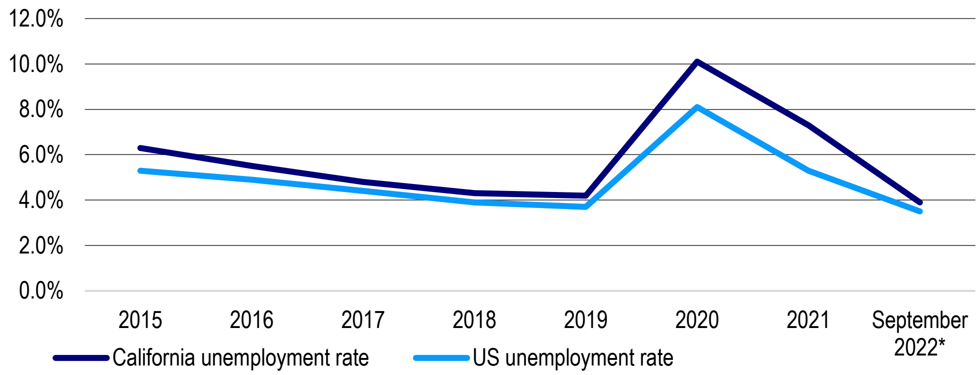
Source: State of California, November 2022.

Economic Update

California has a massive and diverse economy, which is a significant contributor to US economic growth. It has the largest gross state product (GSP), accounting for 15% of national GDP.[12] Even in economic downturns, the California economy has outpaced that of the US. After the onset of the pandemic in 2020, the state's GSP declined by 2.8%, compared to the US GDP decline of 3.5%.[13] California has the largest state population in the US, with approximately 39.4 million people. Since 2012, the average annual population growth rate of the state has been approximately 0.38%, now trailing the 0.62% average annual growth rate of the US.[14]

California income levels also outpace US levels as the state's personal income per capita has increased to over 119% of US per capita family income.[15] California's poverty level of 12.6% of the population is on par with the national level;[16] however, the state's unemployment rate tends to be higher than US levels, even in periods of economic growth. After rising dramatically in the pandemic, the statewide unemployment rate has continued to drop. As of September 30, 2022, the rate was 3.9%, remaining modestly higher than the 3.5% U.S. level.[17]

California vs. US Unemployment Rate (Seasonally Adjusted)



Source: State of California, as of November 2022, except where noted.
*Bureau of Labor Statistics as of September 30, 2022.

12. Preliminary Official statement for State of California general obligation bonds, March 1, 2022.
13. Standard & Poor's, September 2, 2021
14. Based on population data provided in Preliminary Official Statement for State of California general obligation bonds, November 2, 2022.
15. Preliminary Official Statement for State of California general obligation bonds, November 2, 2022.
16. U.S. Census Bureau, as of December 31, 2020
17. U.S. Bureau of Labor Statistics, as of September 30, 2022.

Spotlight on a California Revenue Bond

Issue: San Diego County Regional Airport Authority
Subordinate Airport Revenue Bonds
Project: Terminal Replacement Project
Moody's/Standard & Poor's/Fitch Ratings: A2/A/A+

The Revenue bonds are secured by the San Diego Regional Airport Authority's (the Authority) net revenues generated primarily from San Diego International Airport (SAN). The Airport is located 3 miles northwest of downtown San Diego on 661 acres of land with one 9,401-foot commercial runway, 51 gates in three passenger terminals, and over 585k square feet of rentable terminal space. The airport facilities are located on land leased from the San Diego Unified Port District.[18]

SAN is the primary airport for the San Diego region, with eleven domestic and 5 foreign flag air carriers. Non-stop passenger service is provided to 67 domestic cities and 11 international cities. Five all-cargo carriers also serve the airport, which is the 23rd busiest airport in the United States and the busiest single-runway airport in the nation.[19] Aviation activity peaked in FY 2019 with over 12.4 million passenger enplanements, with an initial impact from the onset of the pandemic being a 25.3% decrease in enplanements for FY 2020 and a further 47.4% decline in FY 2021 to 4.8 million. These enplanements rebounded in FY 2022, more than doubling to roughly 10 million passengers. The rebound is expected to continue in FY 2023, based on a 26% increase during the first three months of the fiscal year.[20]

The cornerstone for the Authority's master plan for the Airport, dubbed the "New T1", is the replacement of the Airport's Terminal 1. The total cost of the New T1, including the replacement terminal, is approximately $3.5 billion. The Authority issued over $1.9 billion of Subordinate Airport Revenue bonds in December 2021 to help finance the New T1 and expects to fund additional project costs from various sources including the issuance of an additional $2 billion of airport revenue bonds in 2024 and 2025.[21]

The rebound in airport enplanements has helped increase coverage levels and reduce airline cost per enplanement (CPE) following the pandemic-related financial impact in fiscal years 2020 and 2021. As with most U.S. airports, the Authority utilized federal Covid aid to maintain debt service coverage above 2.0x in both years. We estimate that debt service coverage would have declined to about 1.85x in FY 2020 and 1.2x in FY 2021, absent the federal assistance. CPE increased moderately to $13.73 in FY 2020 from $10.74 in FY 2019 and jumped to over $26 in FY 2021.[22]

The dramatic increase in airport enplanements in FY 2022 led to a robust increase in operating revenues.[23] We estimate that debt service coverage increased to 2.2x, excluding federal Covid assistance. CPE had been estimated to decrease to $21.51,[24] but with the increase in pledged revenues and availability of remaining Federal Aid, we expect that FY 2022 CPE fell well below $20.

Why Invesco likes the credit

San Diego Airport has a strong service area driven by the stable San Diego economy and tourism demand. The airport has a diverse passenger carrier mix and is not dependent on connecting passenger traffic. The airport's airline agreement provides for protection against increasing costs, including provisions that increase airline rates to maintain stable debt service coverage levels. The cost protections and the term of the agreement through 2029 support the airport's strong market position.

Although the Authority expects to issue more debt to fund its capital program, the debt structure and expectations for continued enplanement growth should mitigate impact on debt service coverage levels and CPE. The Authority has maintained high levels of liquidity, over 1,000 days cash on hand and is expected to maintain levels above its 600-day target.

19. San Diego Airport Official Statement for Series 2021A, B and C bonds, November 17, 2022
20. San Diego Airport Official Statement for Series 2021A, B and C bonds, November 17, 2022, San Diego International Airport Nonstop Destinations as of October 31, 2022
21. San Diego Airport Official Statement for Series 2021A, B and C bonds, November 17, 2022, San Diego International Airport Air Traffic Reports: Monthly, June 2022 and September 2022
22. San Diego Airport Official Statement for Series 2021A, B and C bonds, November 17, 2022, Standard & Poor's credit summary, April 28, 2022.
23. San Diego County Regional Airport Authority FY 2023 Adopted Budget, August 29, 2022
24. San Diego County Regional Airport Authority Finance Committee Report, August 22, 2022
25. San Diego County Regional Airport Authority FY 2023 Adopted Budget, August 29, 2022

Invesco Municipal Bond team

The Invesco Fixed Income Municipal Bond team's investment philosophy is based on the belief that creating long-term value through comprehensive, forward-looking research is the key to providing clients with diversified portfolios that aim to maximize risk-adjusted returns.

Proprietary credit research and risk management are the foundations of our investment process, supported by a deep and experienced team of investment professionals with expertise that spans the entire municipal investment universe. We maintain an integrated, team-based investment process that combines the strength of our fundamental credit research analysts with the market knowledge and investment experience of our portfolio managers.

Our position among the top 10 municipal investment managers by assets in the US enables us to access preferred market opportunities and gain valuable market insight. Our team has established relationships with more than 120 national and regional municipal debt dealers in the US. We believe these established relationships, as well as our size, allow us to achieve fluid execution in daily transactions. Our ability to aggregate trades across multiple portfolios also enables us to obtain lower institutional pricing, which can contribute to portfolio performance.

About risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality.

The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/ or repay the principal on its debt.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They typically pay interest that is a tax in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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Past performance does not guarantee future results.

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Not Rated indicates the debtor was not rated and should not be interpreted as indicating low quality. A negative in Cash indicates fund activity that has accrued or is pending settlement. Pre-Refunded / Escrowed to Maturity (Prerefunded / ETM) bonds are issues backed by an escrow account, invested in US Treasuries, which is used to pay bondholders. Other includes bonds rated below single B and bonds currently not paying a coupon. For more information on the rating methodology, please visit www.standardandpoors.com and select 'Understanding Ratings' under Rating Resources on the homepage; www.moodys.com and select 'Rating Methodologies' under Research and Ratings on the homepage; www.fitchratings.com and select 'Ratings Definitions' on the homepage.

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