Investment Insights

State of the State: California

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Overview

The state of California has remained strong and resilient, and it is well positioned to navigate any potential economic slowdown.

Prudent fiscal management has allowed California to maintain robust budget reserves that could provide a cushion against slowing economic growth.

We highlight the Cedars-Sinai Health System, a leading healthcare provider in the Los Angeles area. We believe Cedars-Sinai is well-positioned as a stable and reputable institution in the competitive healthcare market.

State overview

The Golden State has maintained a financial position that is robust and resilient overall. Having encountered economic challenges in the past, the state has implemented various measures to prepare for a potential economic slowdown, positioning itself to effectively manage such conditions.

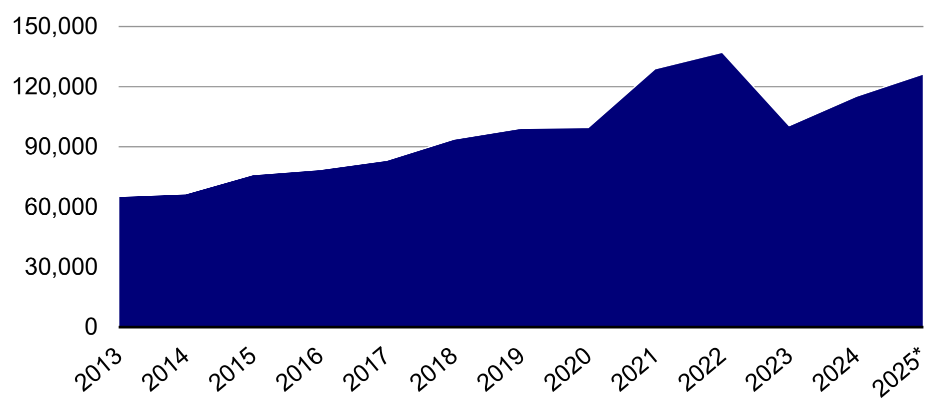
California's tax revenue relies heavily on a small segment of high-income earners, whose personal income taxes have been bolstered by previous periods of economic and market growth. Voters in California have also contributed to increased revenue by approving temporary income tax rates targeting these high earners. Since 2012, a combined top income tax rate of 13.3%, including surcharges on incomes exceeding $1 million, has been in place.[1] Furthermore, state officials have taken a prudent approach to revenue growth forecasts by building reserves, reducing liabilities, and limiting new ongoing expenditures. Voters have supported these efforts by authorizing greater flexibility in the budget process and later approving the creation of additional budget reserves funded by surplus capital gains tax revenues.

Fiscal update: California general fund revenue estimates ($millions)

	FY 2025	% of Total
Personal income tax revenues	126,277	59.3%
Sales and use tax revenues	38,337	18.0%
Corporate tax revenues	41,696	19.6%
Other revenues	6,728	3.2%
Total general fund revenues	213,038	100.0%

Excludes transfers
Source: California State Budget 2025/26

Annual personal income tax revenue ($millions)



*Estimated
Source: Prior California State Budgets through FY 2024; California State Budget 2025/26.

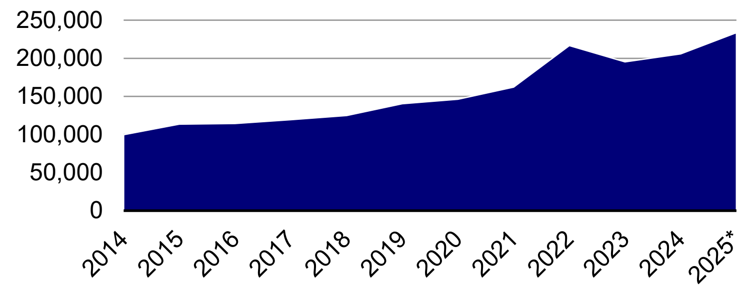
California has achieved a roughly balanced budget for Fiscal Year (FY) 2026 by utilizing a $7.1 billion withdrawal from the budget stabilization account. In FY 2024, the state recorded a general fund deficit of $10 billion; however, California has historically managed such deficits through proactive revenue and expense controls. Years of conservative budgeting and strong tax revenues have allowed the state to maintain a substantial fiscal reserve to offset setbacks. Although the general fund balance declined in FY 2024, it remained robust at $42 billion, equivalent to 20% of expenditures. The reduction in the general fund deficit was primarily driven by increased tax revenues, notably a $15 billion (15% year-over-year) rise in personal income tax revenues, reaching $115 billion.[2] Since personal income tax includes stock-based compensation, a significant portion of this revenue depends on financial market performance and individual investment decisions, making it historically challenging to forecast and budget accurately.

Similar to other states, California has experienced cost pressures from high inflation since early 2021. The governor's office projects a 9% increase in revenues for FY 2025, alongside a 14% rise in expenditures. The most significant expected changes include an 18% increase in corporate tax revenue and a 19% increase in education spending.[2] There is optimism that the projected deficit may be reduced through shifts, deferrals, or cuts in expenses, as well as the potential for higher revenues, particularly from personal income taxes. However, this outlook remains dependent on volatility in equity markets.

California's reserve levels are positioned to help mitigate the impact of any additional deficit in FY 2025. Despite planned reserve usage during the fiscal year, reserves at year end are expected to total $35 billion, representing 15% of estimated expenditures.[2] The state continues to maintain strong liquidity across multiple areas. According to the California State Controller, as of October 31, 2025, the state held cash and internal borrowable resources exceeding $101 billion, a 4.5% increase year over year.[3]

Fiscal update: California general fund expenditures ($millions)

	FY 2025	% of Total
Education	108,260	46.3%
Heath & Human services	76,361	32.7%
Public safety/Corrections	14,010	6.0%
Other expenses	34,946	15.0%
Total expenditures	233,577	100.0%



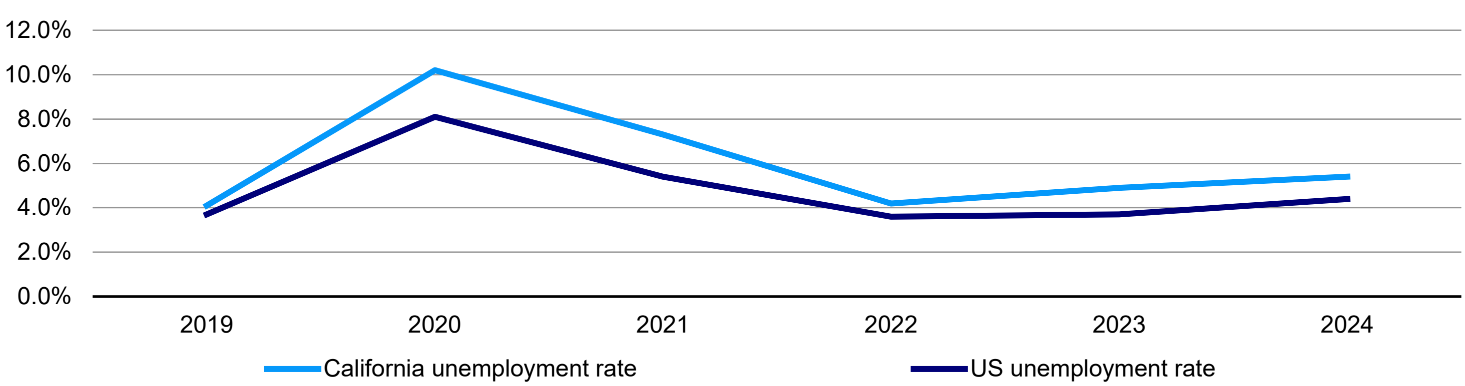
*Estimated
Source: California Governor's Budget 2025/26.

Economic update

California has a massive and diverse economy that plays a major role in driving US economic growth. In 2024, California's real gross state product grew by 3.6%, outpacing the national real gross domestic product growth rate of 2.8%.[4] The state is also the most populous in the US, with an estimated population of 39.4 million people.[5]

Income levels in California have typically exceeded the US levels. In 2023, the state's median household income was $96,334, which was 23% higher than average US per capita family income.[5] Despite this, California's unemployment rate has consistently been higher than the US average, though both have followed similar trends of sharp pandemic spikes and gradual recovery. The unemployment rate rose slightly in 2024, with economic forecasts projecting a rate of 5.3% for the year, gradually decreasing to 4.7% by 2028.[2]

California vs. national unemployment rate (seasonally adjusted)



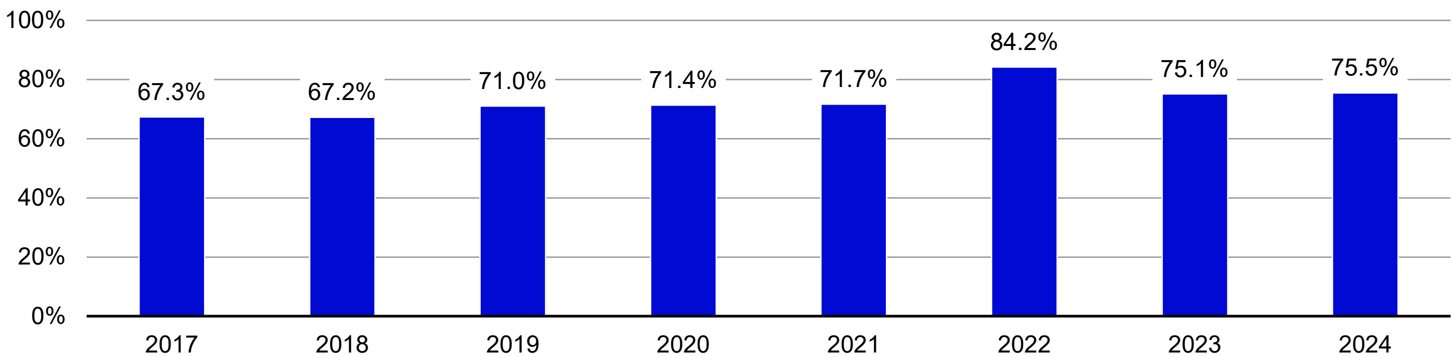
Source: California Department of Finance, Governor's Budget 2025-2026.

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 75.5% in FY 2024.[6]

California has been making extra pension payments, and the proposed FY 2026 budget includes a $1.5 billion supplemental one-time contribution.[2] Future pension funding levels could be impacted by reductions in supplemental contributions and lower investment returns.

State pension funding levels



Source: Merrit Research Services through 2024. Latest data available.

Natural disasters

California has recently experienced extensive periods of drought, leading to severe wildfires. Most recently, the Palisades fire in January 2025 destroyed over 23,000 acres. While these wildfires do pose risks to local communities and governments, they have had a relatively small impact on the state's economy. Further, we believe that insurance proceeds and other federal support will be material as Los Angeles begins the process of rebuilding. Given California's history of managing natural disasters, we believe the state will be able to navigate these recent wildfires through effective fiscal policy. Los Angeles has also already started the process of rebuilding, with sales of land parcels selling for roughly 50% of the home's pre-fire valuations. The parcels are mainly being sold to small and midsize real estate investors and developers. According to S&P's report dated March 3, 2025, Los Angeles County accounts for 21% of California's total personal income tax collections, 28% of corporate taxes, and 32% of the pass-through entity tax, based on 2022 collections.[7]

Issuer spotlight: California state general obligation bond ratings

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. On December 9, 2024, Moody's affirmed its rating and revised its outlook to stable from negative. The Moody's rating balances the state's large economic base, healthy liquidity, and satisfactory level of budget reserves against a highly volatile revenue structure and constraints to operating flexibility. Moody's indicated that its upward outlook revision was based on an easement of fiscal challenges due to the implementation of spending cuts and favorable revenue performance supported by a strong economy.

Standard & Poor's: AA- / Stable 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 December 2023 S&P revised its outlook to stable from positive. The downward outlook revision was based on weaker-than-estimated revenue collections; however, the outlook is stable due to the state's strong fiscal position and tools to manage through this uncertain time. S&P further affirmed its rating and stable outlook in September 2024, citing strong economic metrics, healthy reserves, and moderate debt ratios that together help to offset the state's volatile revenues, high housing costs and minimal prefunding of retiree benefits.

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 on August 16, 2024. 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.

Issuer spotlight: Cedars-Sinai Health System

Moody's: Aa3 / Stable outlook since 01/04/23
Standard & Poor's: AA- / Stable outlook since 02/01/24
Fitch: AA- / Stable outlook since 11/10/21

Cedars-Sinai Health System (CSHS) is a top healthcare provider serving the Los Angeles metro area, including wealthy neighborhoods like Hollywood, Beverly Hills, and West Los Angeles. Each year, it cares for over one million patients across more than 40 locations and employs 4,500+ physicians and nurses.[8] Its core network includes four acute care hospitals with approximately 2,100 licensed beds, plus numerous outpatient clinics and ambulatory centers.[9] The flagship Cedar-Sinai Medical Center (CSMC) has 915 licensed beds[10] and was ranked tied for No. 1 in California and Los Angeles by U.S. News & World Report for 2025-26. CSHS is known for its specialty care, cutting-edge research, and handling very complex treatments. This is reflected in its high Medicare case mix index (CMI)* of 2.26.[10] A higher CMI means the hospital treats more serious and complicated health problems—such as brain surgeries or organ transplants—that need a lot of care. This number gives a clear picture of how sick the patients are and helps the hospital plan its services and budget more effectively.

In fiscal year 2025, CSHS generated $9.26 billion in revenue and maintained strong operating margins, thanks largely to a high percentage of commercially insured patients in its service area.[6] This results in better reimbursement rates from insurers, supporting solid financial performance despite providing $136 million annually in charity care and unreimbursed services. Operating margins dipped slightly to 2.8% in FY 2025 but remain healthy, with cash flow boosted by investment returns.[6] The system's balance sheet is robust, holding over $6.35 billion in unrestricted cash and investments—enough to cover 295 days of expenses—and carrying a manageable $2.55 billion in debt.[6]

CSHS is also a research powerhouse, with 1,500 active projects[8] and $153 million in National Institutes of Health funding in FY 2024.[10] In September 2024, it was named the Official Medical Provider for the 2028 Olympic and Paralympic Games, underscoring its leadership in the competitive Los Angeles healthcare market. Its main rival with similar capabilities is UCLA Medical Center. For investors, CSHS's strong market position, financial stability, and research prominence make it a noteworthy player in healthcare services.

Why we like the credit

People in need of medical attention often seek the highest quality care, and Cedar-Sinai Health System has earned its reputation as a top-tier healthcare service provider in California and the Los Angeles market. We believe its services are steadily in demand, regardless of economic conditions, and are essential to support a healthy community. CSHS is operated by a seasoned and disciplined management team that remains financially responsible, while balancing strategic investment or expansion opportunities. Core financial metrics demonstrate the system's strong financial position, which is supplemented by its ability to fundraise and receive philanthropic gifts such as its latest "Campaign for Cedars-Sinai" that reached its $1 billion milestone in 2024.[11] Collectively, these qualitative and quantitative credit factors support our view of CSHS as a solid credit.

*The Medicare Mix Index is a critical healthcare metric used primarily in Medicare and Medicaid reimbursement. It represents the average relative weight of all Medicare Severity Diagnosis-Related Groups (MS-DRGs) for patients treated within a hospital or healthcare facility during a specific period. It is calculated by summing the DRG weights for all discharges and dividing by the total number of discharges.

1. State of California General Obligation Bonds Official statement, dated October 29, 2024
2. California Department of Finance, California State Budget, dated June 27, 2025
3. California State Controller, dated November 10, 2025
4. Federal Reserve Economic Data, as of December 31, 2024
5. US Census Bureau, as of July 1, 2024
6. Merritt Research Services, as of June 30, 2025
7. S&P Global Ratings, dated March 3, 2025
8. Cedars-Sinai, as of June 30, 2025
9. Cedars-Sinai Continuing Disclosure Agreement, dated November 19, 2025
10. S&P Global Ratings, dated April 21, 2025
11. Cedars-Sinai, as of August 28, 2024

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 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. 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 tax-free 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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A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. NR indicates the debtor was not rated and should not be interpreted as indicating low quality.

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For more information on Moody's rating methodology, please visit https://ratings.moodys.io/ratings and select 'Rating Methodologies' on the homepage.

For more information on Fitch Ratings rating methodology, please visit www.fitchratings.com and select 'Criteria' under 'Resources' on the homepage. Then select 'Rating Definitions' under 'Resources' on the 'Contents' menu.

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