Investment Insights

State of the State: California

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 and market growth. 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 its revenue growth, 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 COVID-19 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 after pandemic’s onset.

Throughout the fiscal year (FY) 2022, California’s fiscal condition continued to outpace expectations. The trend of conservative budgeting and robust tax revenues helped the state maintain large fiscal reserves. Fiscal 2022 reserves had been projected to decline, but ended the year at $76.2 billion, roughly 34% of expenditures.\(^2\) 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 25% higher than budget projections.\(^3,4\) 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 fiscal year 2022.\(^5\)

The state’s level of reserves could help mitigate the impact of an expected decline in state tax revenues in FY 2023. While the governor’s office is currently projecting a 7.5% decline in state tax revenues, the independent California Legislative Analyst’s Office indicates that the drop could be steeper, leading to an 11% decline in fiscal year 2023.\(^4,6\) Despite the estimated revenue decline, budget reserves at the close of fiscal year 2023 are expected to exceed $51.9 billion, which represents a relatively strong 22% of estimated expenditures.\(^4,6\)

Additionally, California’s liquidity remains robust. The California State Controller reported that the state had cash and internal borrowable resources of more than $91.3 billion, as of April 30, 2023.\(^7\)

Fiscal Update: General Fund Revenues

<table>
<thead>
<tr>
<th>California General Fund Revenues* ($Millions)</th>
<th>Fiscal Year 2023</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Income Tax Revenues</td>
<td>122,769</td>
<td>59.4%</td>
</tr>
<tr>
<td>Sales and Use Tax Revenues</td>
<td>33,072</td>
<td>16.0%</td>
</tr>
<tr>
<td>Corporate Tax Revenues</td>
<td>42,091</td>
<td>20.4%</td>
</tr>
<tr>
<td>Other Revenues</td>
<td>8,699</td>
<td>4.2%</td>
</tr>
<tr>
<td><strong>Total General Fund Revenues</strong></td>
<td><strong>206,631</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

* Excludes transfers

Source: California Department of Finance, May 2023.

Overview

Over the last decade, the state of 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.

The state was able to build a large fiscal cushion that helped mitigate the impact of the pandemic. California’s relative economic strength, solid financial market performance, voter-approved procedures providing increased budget flexibility, and continued budget discipline have helped the state to maintain robust budget reserves that could 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.

3. California Department of Finance, Enacted Budget Summary 2021-22, dated June 28, 2021
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, higher inflation, and volatility in the financial markets. Although the state’s high level of budget reserves could help mitigate potential hurdles, it still faces headwinds in the remainder of FY 2023 and beyond. Tax revenues have fallen short of original projections, and a portion of fiscal year 2023 personal income tax receipts will be deferred due to an extension of tax filing deadlines in response to severe winter storms impacting California taxpayers.

The state is projecting that fiscal 2024 general fund revenues will decline by 1.6% from the previous fiscal year. This revenue decline is expected to be driven by a 3.7% drop in personal income tax receipts. The large fund balance included in the state’s budget reserves could help offset the revenue decline. Budget reserves are expected to drop to $37.2 billion in fiscal 2024, but that lever would still provide a solid cushion of nearly 17% of proposed general fund expenditures. While the proposed budget does rely on fund balances, the state’s rainy-day fund would not be utilized. Given the potential volatility of state revenues, California could be forced to tap into more reserves in fiscal 2024, but we believe budget adjustments would be made to mitigate the impact from lower tax receipts.

Personal income tax revenue has been a driver of the state’s revenue growth. Prior to the pandemic, California experienced a long period of economic expansion, robust growth in financial markets, and temporary tax increases, which fueled tax growth that extended into fiscal 2022. As shown in the chart below, personal income taxes more than doubled from $67.3 billion in fiscal 2013 to $137.1 billion in fiscal 2022. 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 fiscal 2021. 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.

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.

Source: California State Controller through FY 2019; California Department of Finance FY 2020 through FY 2023

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. Estimated education expenses for fiscal 2023 are projected to represent 42.3% of state general fund expenditures. Under California statutes, changes in general fund revenues will trigger changes to the amount of spending on education. As revenues grew above original projections in fiscal 2022, budgeted expenditures were revised upward, and as fiscal 2023 general fund revenues have declined, education funding levels have declined.

The state’s second funding priority is debt service. Although California is the largest issuer of municipal bonds, we estimate that debt service will represent only 1.9% of general fund expenditures in fiscal 2023.

<table>
<thead>
<tr>
<th>General Fund Expenditures ($Millions)</th>
<th>FY 2023 Estimate</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>101,548</td>
<td>42.3%</td>
</tr>
<tr>
<td>Health &amp; Human Services</td>
<td>64,790</td>
<td>27.0%</td>
</tr>
<tr>
<td>Public Safety/Corrections</td>
<td>15,822</td>
<td>6.6%</td>
</tr>
<tr>
<td>Debt Service*</td>
<td>4,678</td>
<td>1.9%</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>53,238</td>
<td>22.2%</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>240,076</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: California Department of Finance, January 2023.
*Source: California State Controller, May 2023.

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 increased to 77.6% based on fiscal 2022 valuations. California has been making extra pension contributions from excess capital gains taxes, and the proposed fiscal 2024 budget includes a $1.2 billion supplemental contribution. Future pension funding levels could be impacted by reductions in supplemental contributions and lower investment returns.

Source: Merritt Research Services through FY 2021; Standard & Poor’s for FY 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.11 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%.12 California has the largest state population in the US, with approximately 39.0 million people. Since 2013, the average annual population growth rate of the state has been approximately 0.20%, now trailing the 0.59% average annual growth rate of the US.13 California income levels have typically outpaced US levels but fell below US growth in 2022. While the state’s personal income per capita has increased to nearly 120% of US per capita family income in 2021, it dropped to 118% in 2022.4,11 California’s poverty level of 12.3% of the population is on par with the national level;13 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 through 2022. The rate has ticked up a bit in 2023, and the state’s economic forecast projects a 4.6% rate for the year, versus 3.6% projected for the US as a whole.4

| CA vs US Personal Income Growth (Annual Increase) |
| CA % Change | US % Change | CA % of US Personal Income |
| 2019 | 5.6% | 5.1% | 115.4% |
| 2020 | 8.7% | 6.7% | 118.2% |
| 2021 | 7.7% | 7.4% | 119.8% |
| 2022 | 0.4% | 2.4% | 118.2% |
| 2023 Est | 4.6% | 4.9% |

Source: California Department of Finance, May 13, 2023, and Official Statement for State Public Works, April 12, 2023

| California vs. US Unemployment Rate (Seasonally Adjusted) |
| 2019 | 2020 | 2021 | 2022 | 2023 Est |
| California unemployment rate | 12.0% | 10.0% | 8.0% | 6.0% | 4.0% | 2.0% | 0.0% |
| US unemployment rate | 12.0% | 10.0% | 8.0% | 6.0% | 4.0% | 2.0% | 0.0% |

Source: State of California, as of November 2022, except where noted.

12. Standard & Poor’s, September 2, 2021
13. U.S. Census Bureau, as of December 31, 2021
Spotlight on a California Revenue Bond Issuer

Los Angeles International Airport (Los Angeles World Airports)
Moody's: Aa2/Aa3
Standard & Poor's: AA/AA-
Fitch: AA/AA-

Los Angeles International Airport (LAX) operates on 3,800 acres along the western edge of the City of Long Angeles, approximately fifteen miles from downtown. LAX’s catchment area consists of the Los Angeles-Long Beach-Riverside Combined Statistical Area with a population of nearly thirteen million people. LAX has minimal competition and maintained a dominant market share in catchment area capturing 69% of total enplanements in fiscal year 2022.

LAX’s airline carrier base is diverse with no airline having a dominate market share. Delta Air Lines and American Airlines accounted for 20% and 19% of all enplanements at LAX in Fiscal Year 2022. LAX’s enplanement activity consists primarily of originating and destination, accounting for 85% in fiscal 2022. The airport offers commercial air service to all major cities in the United States and to nearly all key international destinations. Post pandemic, airlines have gradually increased the number of international destinations at LAX from 65 in January 2022 to 70 in January 2023.

Despite a large $15 billion capital spending program—Next Capital Program—to expand and modernize LAX for the upcoming 2028 Los Angeles Olympics, the airport has maintained solid liquidity in both fiscal years 2021 and 2022. Unrestricted cash and investments totaled $1.48 billion, representing 716-days cash on hand in FY 2021, versus $1.41 billion (714-days cash on hand) in Fiscal Year 2022.

Monitoring the financial performance of credits is a primary focus for the Invesco municipal research team as borrowers continue to manage through recent economic challenges. Having characteristics such as a strong liquidity cushion, the ability to access financial markets, and an experienced leadership team are likely to help this organization successfully navigate through this complicated economic environment. The underlying credit qualities at LAX remain strong and have continued to support a bond rating in the AA category.

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 5 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.

*Source: Simfund as of March 31, 2023.
All or a portion of the Fund’s otherwise tax-exempt income may be subject to the federal alternative minimum tax.

The Fund may use leverage to seek to enhance income, which creates the likelihood of greater volatility of the Fund’s shares and may also impair the ability to maintain its qualification for federal income tax purposes as a regulated investment company.

Derivatives may be more volatile and less liquid than traditional investments and are subject to market, interest rate, credit, leverage, counterparty and management risks. An investment in a derivative could lose more than the cash amount invested.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer’s credit rating. Junk bond values fluctuate more than high quality bonds and can decline significantly over a short time.

Inverse floating rate obligations may be subject to greater price volatility than a fixed income security with similar qualities. When short-term interest rates rise, they may decrease in value and produce less or no income and are subject to risks similar to derivatives.

Municipal securities have the risk that legislative or economic conditions could affect an issuer’s ability to make principal and/or interest payments.

Because the Fund invests primarily in a portfolio of one state’s municipal securities, the Fund is more susceptible to political, economic, regulatory or other factors affecting that state than a fund that does not limit its investments to such issuers.

Based on a Master Settlement Agreement (“MSA”) with 46 states and six other US jurisdictions, large US tobacco manufacturers have agreed to make annual payments to government entities in exchange for the release of all litigation claims. Several states have sold bonds backed by those future payments, including (i) bonds that make payments only from a state’s interest in the MSA and (ii) bonds that make payments from both the MSA revenue and from an “appropriation pledge” by the state which requires the state to pass a specific periodic appropriation to make the payments and is generally not an unconditional guarantee of payment by a state. Settlement payments are based on factors, including, but not limited to, annual domestic cigarette shipments, cigarette consumption, inflation and the financial capability of participating tobacco companies. Payments could be reduced if consumption decreases, if market share is lost to non-MSA manufacturers, or if there is a negative outcome in litigation regarding the MSA, including challenges by participating tobacco manufacturers regarding the amount of annual payments owed under the MSA.

The Fund is subject to certain other risks. Please see the current prospectus for more information regarding the risks associated with an investment in the Fund.

**Invesco Limited Term California Municipal Fund:**

There is no guarantee that the Fund’s income will be exempt from federal and state income taxes.

Certain of the municipalities in which the Fund invests, including Puerto Rico, currently experience significant difficulties. Puerto Rico’s economic problems increase the risk of investing in Puerto Rican municipal obligations, including the risk of potential issuer default, heightens the risk that the prices of Puerto Rican municipal obligations, and the Fund’s net asset value, will experience greater volatility. See the prospectus for more information.

The Fund will invest in bonds with short- or intermediate-term (five years or less) maturity which may have additional risks, including interest rate changes over the life of the bond. The average maturity of the Fund’s investments will affect the volatility of the Fund’s share price.

The Fund may invest in municipal securities issued by entities having similar characteristics, which may make the Fund more susceptible to fluctuation. The investment techniques and risk analysis used by the portfolio managers may not produce the desired results.

**Invesco California Municipal Fund:** California’s economic problems increase the risk of investing in California municipal obligations, including the risk of potential issuer default, heightens the risk that the prices of California municipal obligations, and the Fund’s net asset value, will experience greater volatility. See the prospectus for more information.

**About risk**

Invesco does not provide tax advice. The tax information contained herein is general and is not exhaustive by nature. It is not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding tax penalties that may be imposed on the taxpayer under US federal tax laws. Federal and state tax laws are complex and constantly changing. Investors should always consult their own legal or tax advisor for information concerning their individual situation.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

Past performance does not guarantee future results.

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. If securities are rated differently by the rating agencies, the higher rating is applied. 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-Retired / 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.

Diversification does not guarantee a profit or eliminate the risk of loss.

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**Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risk, charges and expenses. For this and more complete information about the funds, investors should ask their financial professional for a prospectus/summary prospectus or visit invesco.com/fundprospectus.**