Invesco

Investment Insights

State of the State: California

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Overview

Over the last decade, the state of California has taken steps to shake off its reputation as a volatile municipal 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 have helped the state to maintain robust budget reserves that could provide a cushion against the current economic downturn.

Invesco is positive on the San Diego County Regional Airport Authority Terminal Replacement Project. We believe with the liquidity on-hand and with airplane travel one the rise, the airport should have strong net revenues.

Invesco's view

The state of California is facing some economic headwinds, but California took various steps in anticipation of a potential slowdown that leaves them well positioned to navigate the situation.

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 past times of 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] State leaders exercised caution with its previous 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.

While the governor's office is currently projecting a 9% increase in revenues in 2024, it's also projecting a 15% increase in expenditures.[2] The largest expected increases in revenue and expenses is for a 12% increase in Personal Income Tax Revenue and a 35% increase in Health and Human Services expenditure. There is hope that the projected deficit could be smaller due to a shift, deferral, or reduction of expenses. There is also the possibility of higher revenues, especially for personal income taxes since there has been positive financial market performance this year.

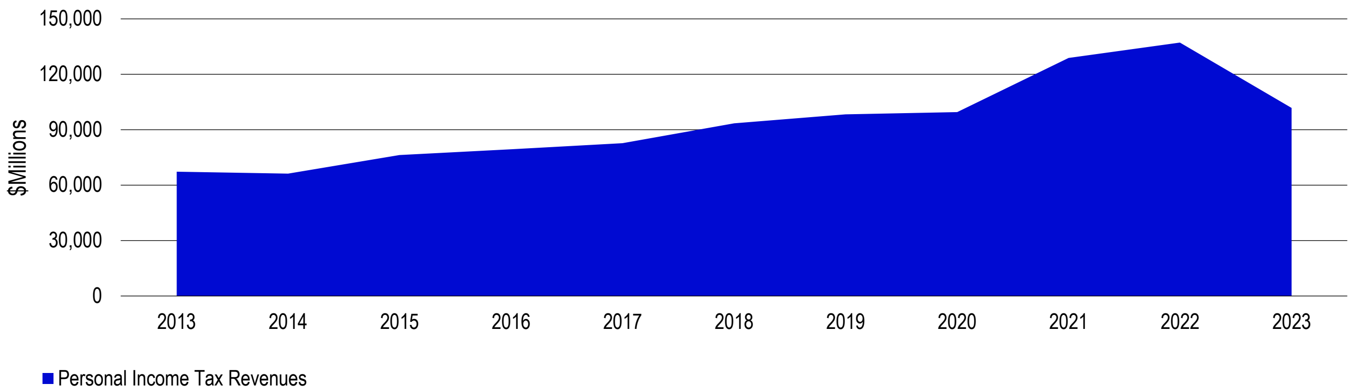
The state's level of reserves could help mitigate the impact of an additional deficit in FY 2024. Despite the budgeted use of reserves in FY 2024, reserves at the close of fiscal year are expected to be $8 billion, which represents 3% of estimated expenditures. The state continues to have ample liquidity in multiple areas. The California State Controller reported that the state had cash and internal borrowable resources of more than $93 billion, as of January 31, 2024.[3]

Fiscal Update: General Fund Revenues

California General Fund Revenues* ($Millions)	Fiscal Year 2023	% of Total
Personal Income Tax Revenues	101,749	56.2%
Sales and Use Tax Revenues	37,346	20.6%
Corporate Tax Revenues	37,139	20.5%
Other Revenues	4,909	2.7%
Total General Fund Revenues	181,143	100.0%

*Excludes transfers
Source: California Governor's Budget 2024-25

California's Personal Income Tax Revenue



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

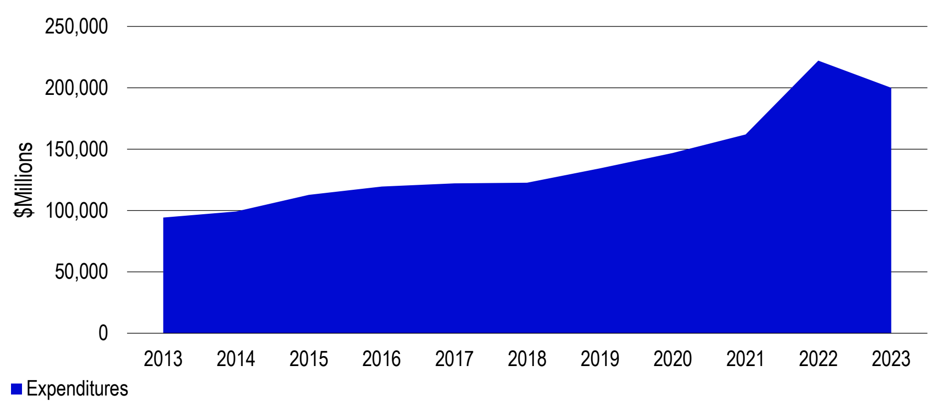
Fiscal Update: General Fund Expenditures

In the fiscal year 2023, California expects to have generated a $20 billion deficit.[2] Their years of conservative budgeting and robust tax revenues provided the state a large fiscal reserve to help somewhat offset this setback. Fiscal 2023 reserves declined but remain healthy at $42 billion, roughly 21% of expenditures.[2] California's decline in reserves was driven largely by lower tax revenues. More specifically, the decline in revenues was largely from a $35 billion decline (26% change year over year decline after spiking to an all-time high in 2022) in personal income tax revenues to $102 billion.[2] Since personal income tax includes stock-based compensation, a meaningful amount of personal income tax depends on the performance of financial markets and individual taxpayers' investment decisions. Historically, these revenues have been difficult to project and budget for.

General Fund Expenditures ($Millions) Excludes Transfers		
	FY 2023 Estimate	**% of Total**
Education	90,659	45.3%
Health & Human Services	55,003	27.5%
Public Safety/Corrections	15,144	7.6%
Other Expenses	39,269	19.6%
Total Expenditures	200,075	100.0%

Source: California Department of Finance, January 2023.

General Fund Expenditures

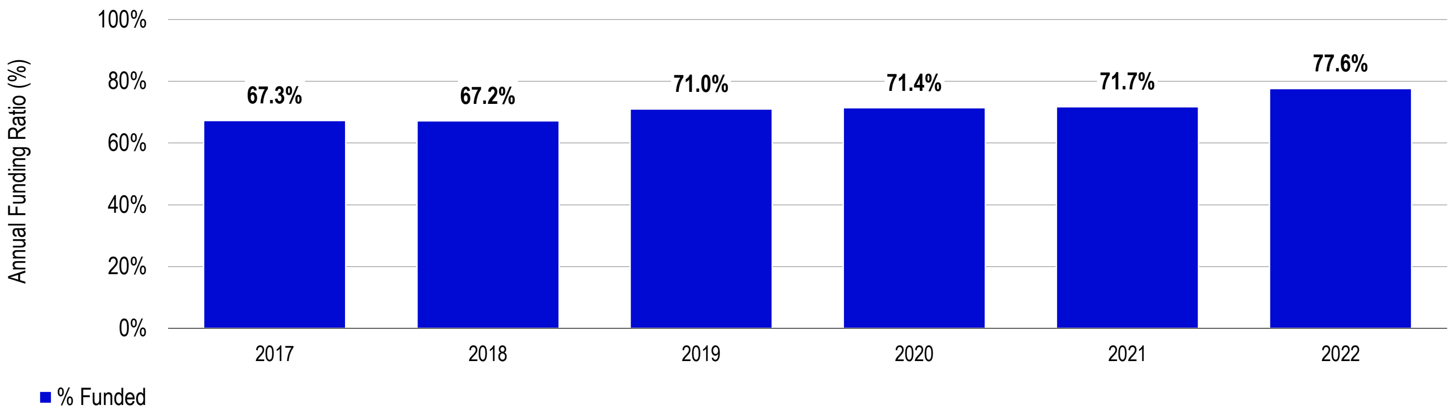


Source: California Department of Finance, as of January 2023.

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.[7] California has been making extra pension, and the proposed fiscal 2025 budget includes a $0.9 billion supplemental one-time contribution.[2] Future pension funding levels could be impacted by reductions in supplemental contributions and lower investment returns.

California's Pension Funding Levels



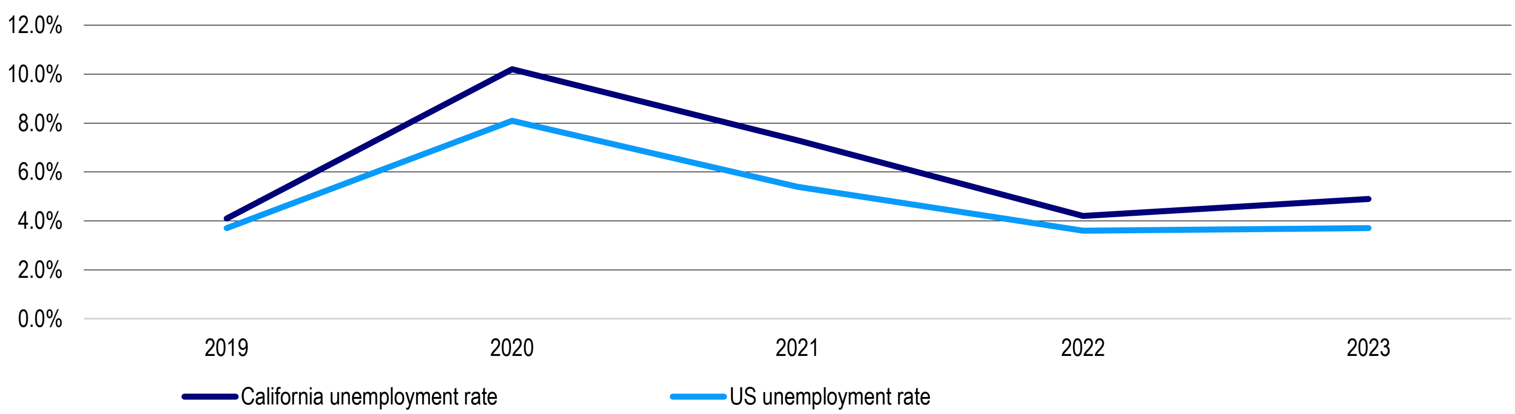
Source: Merritt Research Services through 2021; Standard & Poor's, December 2023.

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.[4] In 2023, the gross state product grew 1.9% compared to the national gross domestic product growth of 2.4%.[5] California has the largest state population in the US, with approximately 39.0 million people.[6]

California income levels have typically exceeded the US levels. The state's median household income ($91,905) is 122% of US per capita family income in 2022;[6] however, the state's unemployment rate tends to be higher than US levels, even in periods of economic growth. The rate 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.[2]

California vs. US Unemployment Rate (Seasonally Adjusted)



Source: California Department of Finance, Governor's Budget, as of January 2024.

Issuer Spotlight: California State General Obligation Bond Rating

Moody's: Aa2/Negative Outlook
Moody's has rated the state of California's general obligation bonds Aa2 since its last upgrade in October 2019. On May 19, 2023, Moody's affirmed its rating, but revised its outlook to Negative. Moody's rating balances the state's large economic base and elevated level of budget reserves against a highly volatile revenue structure and constraints to operating flexibility. Moody's indicated that its outlook revision was based on a weakened and uncertain revenue environment.

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 and affirmed the rating. The outlook revision is based on weaker-than-estimated revenue collections is stable based on the states strong fiscal position and tools to manage through this uncertain time. S&P's rating incorporates strong economic metrics, healthy reserves, and moderate debt ratios that together help to offset the states 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 October 26, 2023. 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: California Revenue Bond Issuer San Diego County Regional Airport Authority Terminal Replacement Project

Moody's: A2
Standard & Poor's: A
Fitch: 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 three 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 five foreign flag air carriers. Southwest Airlines is the largest carrier with 35% of traffic. 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. Aviation activity peaked in FY 2019 with over 12.4 million passenger enplanements, and subsequently declined during 2020 and 2021 due to restricted travel during the early years of the pandemic. Enplanements doubled year-over-year in FY22, and rebounded a further 17% in FY23, ending close to the prior 2019 high of 12 million.[18]

The Authority's master plan calls for the replacement of the Airport's Terminal 1 in order to support passenger growth and better serve the Airport's customers. The total cost of the New T1 is approximately $4 billion. The Authority issued over $1.9 billion of Subordinate Airport Revenue bonds in 2021 and $1.1 billion of Senior Airport Revenue bonds in 2023 to help finance the New T1.[18]

Why Invesco likes the credit

San Diego Airport has a favorable service area, effective management system in place, and strong support from the airlines. San Diego has a diversified economy anchored by a vibrant tourism industry and large U.S. Navy presence, as well as numerous defense contractors and biotech companies. With enplanements nearly back to pre-pandemic levels and projected growth expected to continue, Invesco expects the airport to generate strong net revenues which support debt service coverage. The Authority also maintains high levels of liquidity, with over 1,000 days cash on hand at end of fiscal 2023.[18]

San Diego County Regional Airport issues comprised 0.16% of Invesco Limited Term California Municipal Fund's (OLCAX) portfolio and 3.01% of Invesco California Municipal Fund's (OPCAX) portfolio as of December 31, 2023. The Funds have no exposure to Delta Air Lines and American Airlines. Holdings are subject to change without notice.

1. State of California general obligation bonds Official statement Sept. 2, 2020
2. California Department of Finance, Governor’s Budget, dated January 10, 2023.
3. California Department of Finance, Enacted Budget Summary 2021-22, dated June 28, 2021
4. California Department of Finance, May Revision to the Governor’s Budget, dated May 12, 2023.
5. California Department of Finance, Governor’s Budget Summary 2022-23, January 2022.
6. Legislative Analyst’s Office, The 2023-24 Budget: May Revenue Outlook, May 13, 2023.
7. California State Controller, dated May 10, 2023.
8. California State Controller, Statement of General Fund Cash Receipts and Disbursements, July 2013.
9. California Legislative Analyst’s Office, California Fiscal Outlook, November 2022.
10. California State Controller, Statement of General Fund Cash Receipts and Disbursements, May 2023.
11. Standard & Poor’s, March 2023.
11. State Public Works Board Lease Bonds Official Statement, dated April 12, 2023.
12. Standard & Poor’s, September 2, 2021
13. U.S. Census Bureau, as of December 31, 2021
16. Los Angeles International Airport 2023 Series Official Statement, dated March 28, 2023.
17. Merritt Research Services, as of June 30, 2022.
18. San Diego Airport Official Statement for Series 2023A, B bonds, October 11, 2023.

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 December 31, 2023.

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-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.

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

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