California Update: It's All Good – For Now
by Howard Cure

September 2019

California's Bond Market in an Era of Economic Strength, Housing Shortages and Climate Change

Introduction

California has a massive and diverse economy that has performed well for years relative to the rest of the nation. This performance has supported robust state government revenue growth and, in combination with budgetary reforms, led to the accumulation of healthy liquidity for the state and to multiple rating agency upgrades for state debt.

But not all state residents have benefited from this prosperity. Significant issues need to be addressed, notably the intolerably high cost of living for many, particularly for homes along the coastal counties and within the San Francisco Bay. This housing issue, further complicated by high income taxes and a difficult regulatory environment, is forcing prospective homeowners farther from their jobs and into areas that can be more prone to wildfires.

The ramifications of this growing wealth gap may soon affect investors, hampering growth and leading to economic retraction. However, the state has shown considerable fiscal discipline in structurally balancing its own budget and has renewed its focus on addressing the housing issues, as well as funding programs to support lower- and middle-income families.

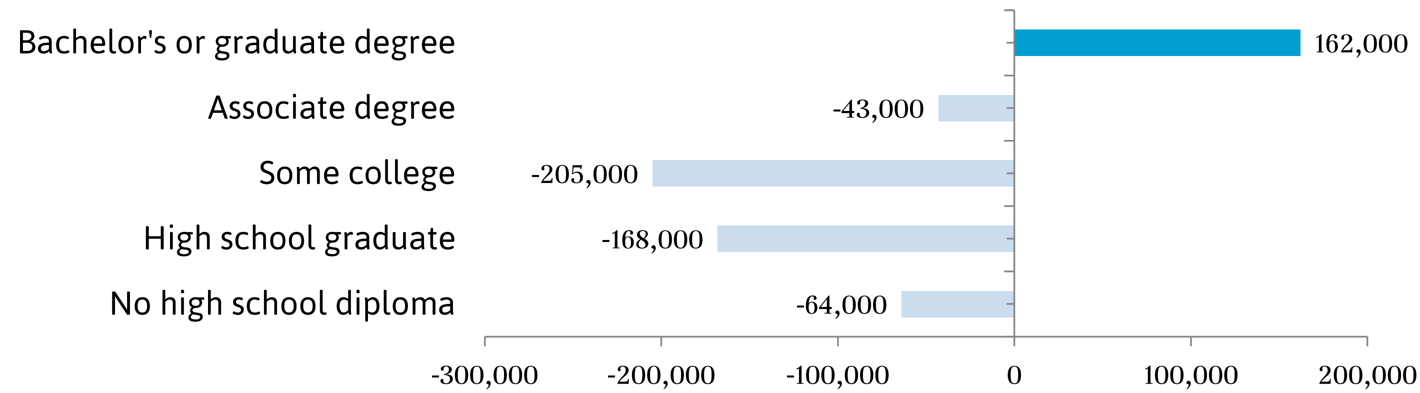
Strong Economics and the State Budget

For the ninth straight year, California has enacted its annual state budget on time, in happy contrast to earlier delays that affected payments to schools, local governments, businesses and others who rely on the state to pay its bills. California's fiscal 2020 budget simultaneously expands programs and pays down long-term liabilities, while maintaining strong reserves.

Recent state budgeting has been conservative, setting aside monies in reserves as dictated by Proposition 2.[1] By the end of the 2020 Fiscal Year, California is slated to have \$19.2 billion in reserves out of a \$147.8 billion general fund budget. These reserves are intended to minimize any significant cuts to programs when the next recession arrives. Actions mandated by Proposition 2 have contributed to an improvement in the state's General Obligation rating to "AA" from "A."

California's heyday of rapid population growth – the post-World War II era – was fueled by millions of migrants coming to the state from the rest of the country. Those days are over. While California's population continues to grow (through births and international migration), it also loses tens of thousands of people every year to other states, with the exception of one group: college graduates between the ages of 20-29. Over the past five years, California has attracted 162,000 more college graduates (with at least a bachelor's degree) from other states than it has lost.[2] Many head to the San Jose and San Francisco metropolitan areas, both of which now rank among the top 10 concentrations of educated Millennials, according to a recent Brookings report.[3] Four of the bottom-10 areas (Bakersfield, Stockton, Riverside and Fresno) are also in California, a disparity that highlights the uneven geographical distribution of wealth in the state.

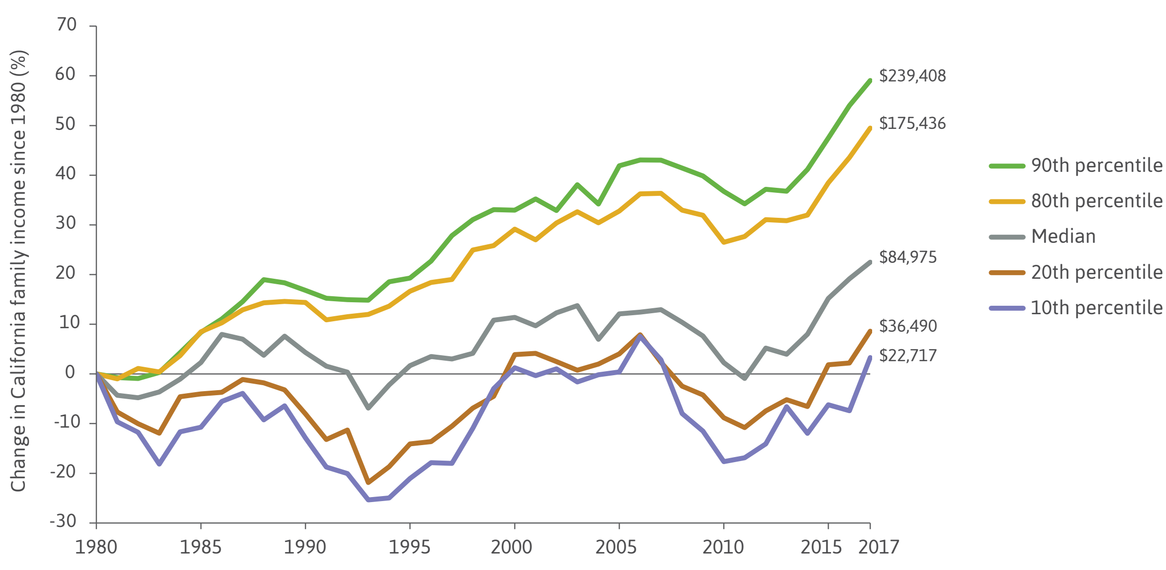
California Gains College Graduates While Losing Less Educated Adults



Source: PPIC Calculations based on American Community Survey data.
Note: Negative numbers reflect net migration out of California, positive numbers reflect net migration to California. From: PPIC Blog, July 2019

From a labor market perspective, attracting young college graduates is especially advantageous. Young adults with college degrees are at the start of their careers and provide the state with educated workers. However, this trend also contributes to the increasing income disparity.

Income Inequality is High by Historical Standards—Even Though Family Incomes Have Risen



Source: Author calculations from Current Population Survey Annual Social and Economic Supplement data.[4]
NOTE: Income is defined as all cash earned or received in a family unit, in 2017 dollars, and adjusted to pertain to a family of four.

The median or "middle-income" family of four in California today is doing about 22% better than the median family in 1980, based on income ($84,975 in 2017 and $69,372 in 1980, in today's dollars).[4] However, the middle-income family – as well as families earning less – has fallen behind the top half of the income distribution. Top-income families (the 80th and 90th percentiles) earn at least 50% to 60% more today than in 1980. This income polarization is driven by labor market shifts that favor college degree holders as well as by boom and bust cycles.

Improving access and degree completion in the state's own colleges and universities is an expensive goal. With forecasted revenue growth of over 4%, the 2020 state budget has expanded higher education funding. California also has shown increasingly active budgetary support for lower- and middle-class family programs. Many of these additional allocations do have sunset and one-time funding provisions so as not to perpetually burden state finances. This is a testament to conservative budgeting practices. Areas with expanded funding include:

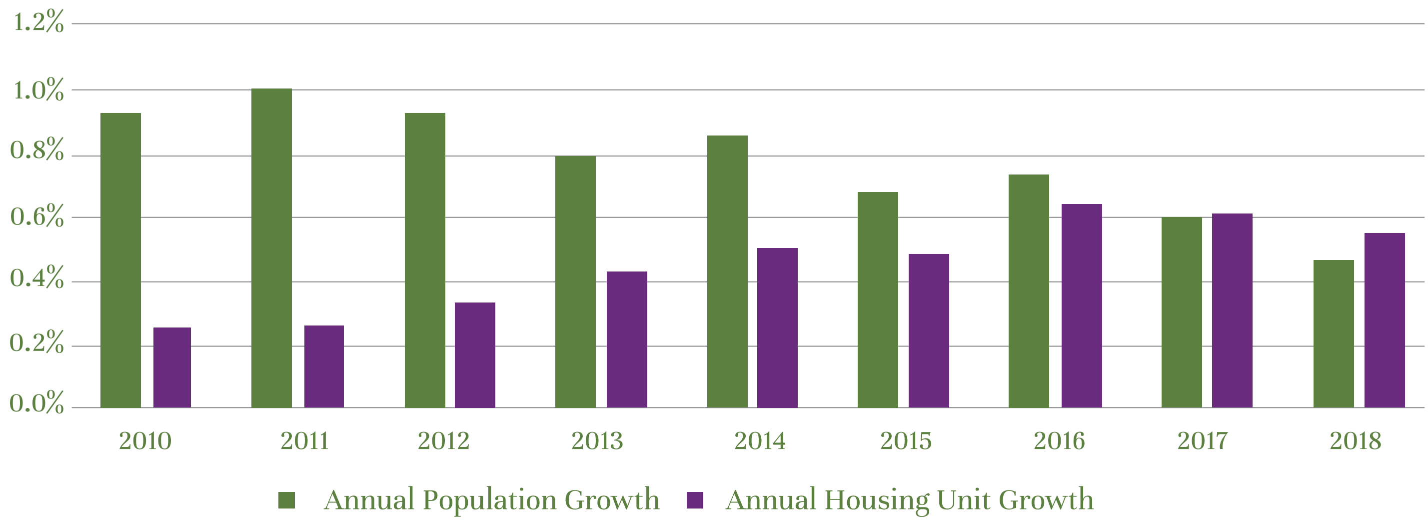
- Growth in pre-K-12 education per pupil funding,
- Expanded full-day pre-school for income-eligible families,
- Higher education,
- Free community college tuition for first-time full-time students,
- $1 billion in an expanded earned income tax credit,
- Medicaid eligibility expanded to higher proportions of the federal poverty level,
- $1.3 billion of increased Medicaid provider payments, with a December 31, 2021 statutory sunset if general fund revenue are forecast to be insufficient,
- Medicaid expanded to undocumented aliens under the age of 26,
- $358 million restoration of increased support for in-home supportive services (with a statutory sunset in the event of low revenue growth)
- $650 million on one-time funds to help local governments fight homelessness,
- $750 million in one-time housing programs for localities, and
- $918 million ($202 million ongoing) additional funding to address wildfires.

So far, the state has shown the fiscal discipline to manage the needs of its many vulnerable residents, while living within its means. But the key credit question is: How prepared is the state for the next economic downturn in light of its historically cyclical finances? The state budget is subject to some cyclicity,[5] given its highly progressive income tax, constitutionally mandated school spending, and a legislative supermajority required to raise tax rates without a popular vote. Liquidity is considered healthy owing to the Budget Stabilization Account mechanism. Another concern is the state's vulnerability to changes in federal policy and funding, especially with regard to healthcare. Is California willing to replace cuts to Medicaid or Medicare programs using its own resources? It seems likely that the state will continue its fiscal discipline and refrain from tapping its own resources to backfill federal budget cuts. This is partly in recognition of the high and progressive tax rates reimposed on its citizens. It should be noted that some of these difficult tradeoffs could be alleviated with more generous federal funding.

Housing

California continues to have persistently high costs of housing relative to that in other states, which poses a threat to its longer-term economic growth prospects. Housing is a substantial problem, not just for families trying to pay rent but also for companies trying to attract and retain workers. In fact, notable shifts in the state's demography are already in evidence. Population growth in 2018 was the slowest in that state's recorded history, as Californians migrated to other states and fewer immigrants came to California.[6] At this rate, the state may face a future without the diverse workforce that fuels economic success.

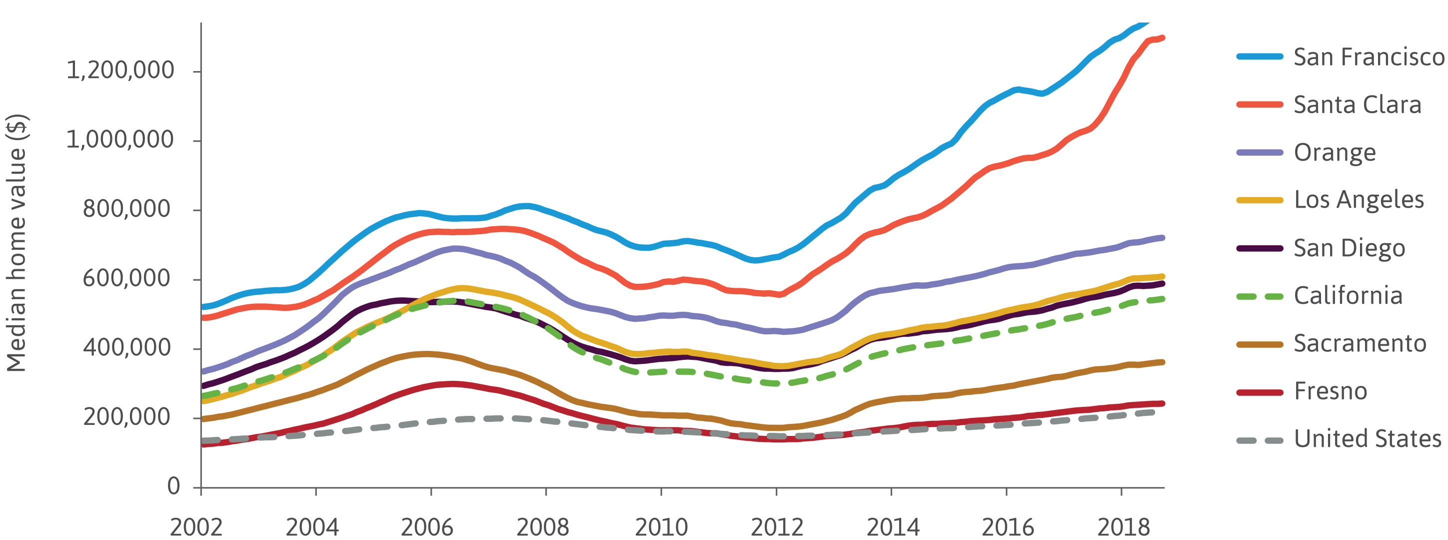
California Housing Unit Development Has Lagged Population Growth



Source: California State Controller: *Elevating Our Ambition to Confront California's Housing Needs* – June 2019

The state is home to the ten least-affordable major markets in the country and ranks near the top in cost-burdened households – second among homeowners and fourth among renters.[7] It also has the second-highest homelessness rate, the second-lowest homeownership rate, and the second-lowest number of housing units per capita.[8]

Home Values are High and Rising but Wide Variation Exists Across the State



Source: PPIC Housing – California's Future "California's Housing Challenges Continue."

Also worth noting is the need for more multifamily buildings and how cities use zoning to deter this development. If housing markets are functioning well, we would expect to see more new apartments constructed in communities with high initial rents. But many affluent communities are hostile to apartments and adopt zoning and related policies intended to limit development.

The state has some legal and financial tools at its disposal that it could use more aggressively. For example, statewide funds that are dispersed to localities for transportation projects and schools could be made contingent on increased housing production. Although local governments are currently required to submit a housing plan to the state Department of Housing and Community Development, there have been few consequences for localities that fail to meet their plans.

Public Funding for Housing

In November 2016, voters in Los Angeles approved Proposition HHH, authorizing the city to issue up to $1.2 billion in general obligation bonds to buy, build or remodel facilities to provide supportive housing for homeless individuals, temporary shelters and facilities, affordable housing for veterans and low-income households, and other related infrastructure. In Alameda and Santa Clara counties, bonds were authorized for housing purposes for $580 million and $950 million, respectively. Bond proceeds are designated to help construct housing, offer home-buying assistance and provide services for the homeless population.

Statewide, Californians in November 2018 approved two large bond propositions intended to fund housing related programs. Proposition 1 authorized $4 billion in general obligation bonds for a variety of housing programs, including $1 billion for California's Veteran Home Loan Program. Proposition 2, which authorized up to $2 billion in revenue bonds for homeless prevention programs, aims to finance about 20,000 new supportive housing units for homeless residents.

Another Challenge to Proposition 13

For the last 40 years, California's property tax system has operated under the Constitutional dictates of Proposition 13 passed in 1978.[9] This limit on property tax rates and assessments has required the state to increasingly rely on personal income, sales and other taxes to fund many local government operations, particularly K-12 school districts and community colleges. In November 2020, a new proposition would split the property tax roll, keeping the Prop 13 tax limits for residential, small business and agricultural property, but eliminating those limits for high-dollar commercial and industrial building and land. Under Prop 13, property is reassessed only when it changes hands. In practice, that has resulted in more frequent reassessments for residential property. Large commercial properties often remain under one owner for decades. Some are still taxed based on 1970s assessments.

The new measure will try to ensure that every school district and local government receives a share of the estimated[10] $7 billion-$11 billion windfall anticipated from the tax changes. If the past serves as a guide, voters adamant about protecting the tax limits on residential property may not feel the same way about commercial property.

California and the Wildfire Fund

California wildfires caused substantial damage in 2017 and 2018. The state's largest investor-owned utility, Pacific Gas & Electric, declared bankruptcy in January 2019 because it faced potentially more than $30 billion in liabilities stemming from the role its infrastructure played in causing or spreading wildfires. However, many factors contribute to growing wildfire damages. These include:

- Development in formerly sparsely populated areas of the state due to growing population and costs associated with living closer to major cities. These areas know as wildland urban interface (WUI) have increased the overall risk of wildfire damages by increasing the likelihood of fires starting in these areas as a result of the additional human activity and infrastructure, and the amount of potential damage when fires occur. There are estimates of over three million California households in these areas.[11]
- Forest management practices – such as decades of fire suppression – have contributed to a significant build-up of vegetation in the forest that serves as fuel for more intense wildfires.
- Climate change is contributing to longer fire seasons, and a severe drought earlier this decade has led to an increase in dead trees and fuels.
- Utility equipment has ignited some of the most damaging fires in the last couple of years. Mismanagement of these assets is of increasing concern.

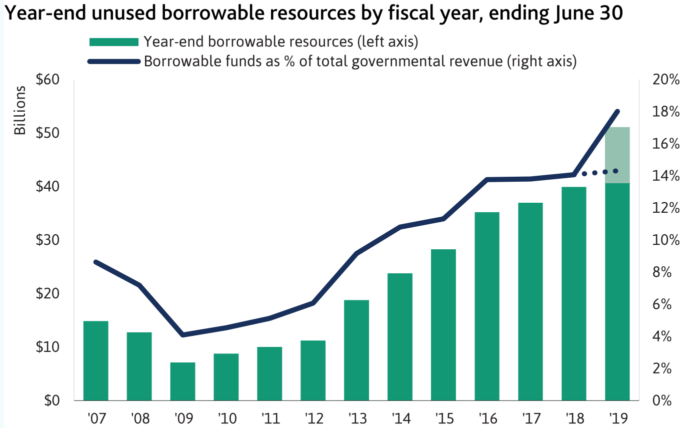
California has historically had moderate insurance losses compared with those of hurricane-exposed states. However wildfire losses drove California homeowners' insurance loss ratios to the highest in the nation in 2017-18.[12] Insurers are now raising rates, particularly in wildfire-exposed regions and WUI areas. California homeowner insurers are also issuing non-renewing policies, particularly in WUI regions, while enhancing underwriting standards, conducting inspections and requiring homeowners to take steps to reduce wildfire risk. All of this may lead to an underinsured population.

In July 2019, Assembly Bill 1054 was signed into law, which established a wildfire fund of up to $21 billion that covers participating investor-owned utilities (IOUs) Pacific Gas & Electric, Southern California Edison and San Diego Gas & Electric. The legislation also established wildfire safety requirements that utilities must meet to participate in the fund and pays insurer subrogation (the legal pursuit of insurers to recover claims payments) claims quickly if insurers agree to significant discounts.

The $21 billion fund will initially be funded with $10.5 billion from the state treasury but then securitized starting in 2020 by a charge to customers (extending the existing surcharge placed on IOU customers initiated by the last energy crisis and in place since 2003), and $10.5 billion paid by the electrical utilities ($7.5 billion initially and $300 million per year over the next 10 years). In addition, the fund will require electrical utilities to have a valid wildfire safety certification from the California Public Utility Commission and to meet other conditions to be eligible to gain access to the fund, which should result in stronger wildfire safety standards.

California closed fiscal 2019 with more than $50 billion of available liquidity, and a loan as high as $10.5 billion would leave these resources at a healthy level

Year-end unused borrowable resources by fiscal year, ending June 30



The dotted line shows liquidity as a percentage of revenue if the state makes a $10.5 billion loan to the Wildfire Fund.

Sources: State of California, Moody's Investors Service[13]

The legislation is beneficial for the state and its local governments for several reasons. The liquidity made available to the utilities could assist them in paying claims without immediately raising the rate burden as much as they otherwise might;

- The fund should reduce the risk of a future utility bankruptcy and any ensuing uncertainty in the state's power market, and,
- The legislation requires that the first $5 billion of safety investments made by the investor-owned utilities be financed without the ability to earn a profit on the investments.

The legislation accomplishes these objectives without a significant reduction in the state's own resources and without an immediate increase in cost to taxpayers. The state's use of its own liquidity to set up the fund would likely raise credit concerns if not for two key factors. First, California's liquidity has never been stronger and the state can afford to make the loan, as demonstrated in the prior chart. Second, the act authorizes the California Department of Water Resources to issue up to $10.5 billion of bonds to repay the state's loan.

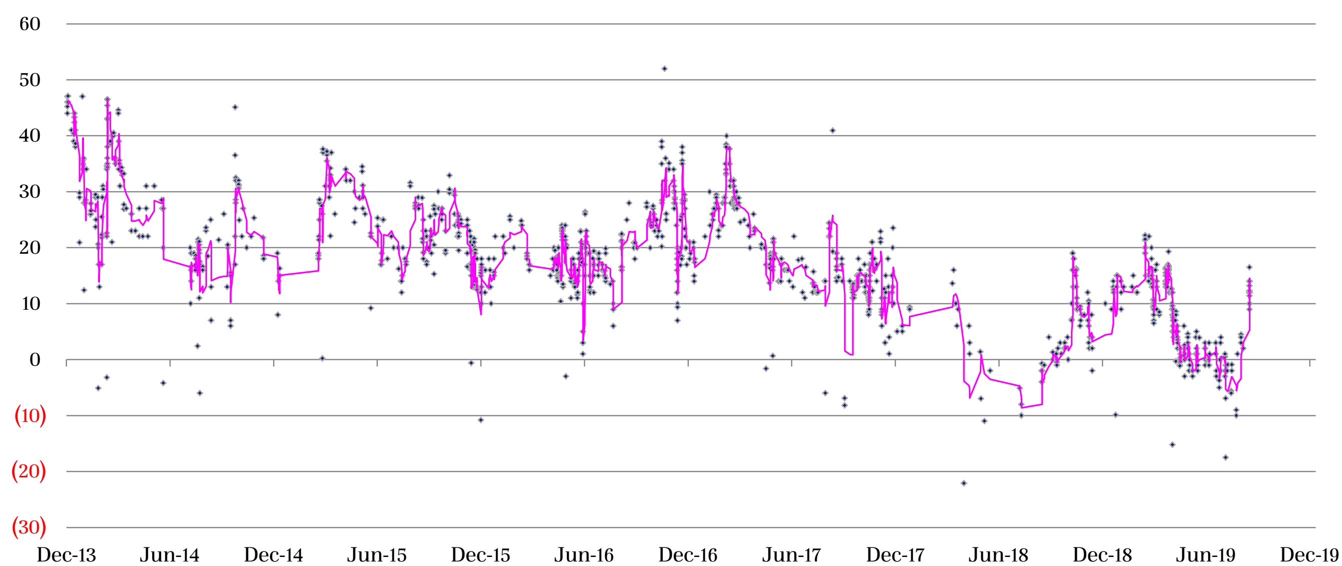
While much of the public attention has been directed at PG&E and other IOUs, municipal utilities and joint-action agencies are not immune to inverse condemnation wildfire-related liability risk. Inverse condemnation requires compensation to private property owners whose property is damaged by public use property, regardless of whether the public entity acted negligently or violated regulations.

Municipal utilities have a higher degree of certainty around inverse condemnation cost recovery because local rate autonomy enables them to pass through such costs. However, it should be noted that customer pushback to a municipal rate increase could occur if the size of the claim is material. Although municipal utilities do not have access to the $21 billion fund, from a physical perspective, wildfire exposure is much lower than the IOUs' because of the topography and the size of the service territories.

California Trading Values

As indicated in the spread chart, the municipal market has recognized the progress made by the state, based on trading values for 10-year, non-callable, State of California general obligation debt compared with the gilt-edged AAA scale.

California GO's—Spread to AAA Municipal Market Data (basis points)
Uninsured, Aa3/AA-/AA, 5.00% Cpn, 9 to 10-Yr Maturities, Non-Callable



Source: Loop Capital Markets.

Spreads have tightened for the state of California for a number of reasons. The market has recognized the state's fiscal achievements over the last few years in cutting expenditures, raising taxes and establishing mechanisms to maintain various liquidity funds. Other market factors are also in play to explain the tightening of spreads.

The Tax Cuts and Jobs Act of 2017, or TCJA, eliminated the ability to advance refund debt issuances. As a consequence, total municipal volume is below recent yearly averages and demand is chasing less supply. The TCJA also implemented a cap of deducting state and local taxes. This has prompted investors in higher-tax states to seek tax-exempt income, which has led to significant inflows into municipal bond funds, especially funds targeting residents of high-tax states such as California.[14]

California has demonstrated discipline in structurally balancing its budget, focusing on eliminating what Governor Brown described as its "wall of debt"[15], and establishing substantial rainy-day reserves. That state has a long way to go, however, and the dependencies associated with its progressive tax structure makes it vulnerable.

We continue to recommend diversifying a California portfolio with essential purpose revenue bonds and enterprise systems such as water and sewer issuers, public power systems not vulnerable to wildfires, airports, ports, and public university system debt. These should prove relatively robust if the state's financial position deteriorates.

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[1] Proposition 2 is a constitutional amendment that provides for a 15 year period, starting in 2016, where 1.5% of annual general fund revenues, plus the excess of capital gains tax receipts above 8% of general fund revenues, is applied equally to funding a Budget Stabilization Account and paying down debts and liabilities.

[2] Public Policy Institute of California: "California's Brain Gain Continues," July, 2019.

[3] Brookings: Where do the Most Educated Millennials Live? William H. Frey, February 7, 2018.

[4] Public Policy Institute of California, California's Future – Economy: California's Economy is Strong, but Persistent Disparities Could Affect Long-Term Growth, January 2019.

[5] The fiscal 2020 budget projects personal income tax will account for 70% of total general fund tax revenue. Assuming the top 1% account for the same 46% of total income tax as they comprised in 2018, it would imply that approximately 32% of total budgeted fiscal 2020 general fund revenue would be attributable to the top 1% of income taxpayers.

[6] California Fiscal Focus – A Monthly Report from State Controller Betty Yee; "Elevating Our Ambition to Confront California's Housing Needs," June 2019.

[7] Public Policy Institute of California, "California's Housing Challenges Continue," January 2019.

[8] New York State ranks number one in all other categories with the exception of number of housing units per capita where Utah is number one in the country.

[9] Under Proposition 13, property tax rates are capped at 1% plus smaller voter-approved rates to finance local infrastructure. A property's assessed value is based on its purchase price and thereafter, the property's taxable value increases by 2% or the rate of inflation, whichever is lower. This process continues until the property is sold and again is taxed at its purchase price. In most years, the market value of most properties grows faster than 2% per year. As a result, under this system the taxable value of most properties is less than their market value.

[10] California Legislative Analyst's Office memo 2/5/18 reviewing the proposed constitutional initiative related to taxation of commercial property.

[11] California Legislative Analyst Office, "Allocating Utility Wildfire Costs: Options and Issues for Consideration" – June 2019.

[12] Moody's Investors Service: "California Homeowners Insurers Cut Wildfire Risk," August 7, 2019.

[13] Moody's Investors Service: "State of California: Wildfire Fund will Reduce Likelihood of Utility Bankruptcies and Market Uncertainty, a Credit Positive for the State"

[14] California has the highest marginal tax rate in the country at 13.3% for an income of just over $1.07 million.

[15] Governor Brown had estimated that the "Wall of Debt" totaled $34.7 billion with one-third being owed to public schools resulting from cuts made during recession years. Other areas include repayment of deficit budget bonds, loans form special funds, unpaid cuts to local governments, deferred Medi-CAL costs and state payroll costs including CALPERS and borrowing from state transportation funds

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