SEI Fixed Income Portfolio Management:
A Brighter Outlook for California Bonds
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Moody's Investor Service officially upgraded the credit rating for the State of California from A1 to Aa3 with a stable outlook. The June 25, 2014 upgrade takes the state to a level not seen since the 2001 fiscal year. The upgrade affects almost $90 billion in outstanding debt, the majority of which is backed by a general obligation pledge. Following the positive movement in credit, the lease appropriation debt for the State, which was rated A2, improved one-notch to A1. SEI Fixed Income Portfolio Management has been a buyer of the state and its associated credits over the past 24 months after changing our stance on the credit following positive legislative moves strong voter support for new tax initiatives to save school funding.

California remains one of the largest states by financial measurement. It gross product of almost $2 trillion contributes almost 12% to national gross domestic product. If California were a stand-alone country, it would have one of the world’s largest economies. Because of sheer physical and fiscal size, the state is one of the largest issuers of municipal debt including issuance from many state-related agencies. As such, it is one of the larger exposures in our portfolio with state direct debt outstanding of $28 million, comprising just under 1% of assets.

As the economy hit the skids in 2008 and the great recession took hold, California fell harder and faster than many of its peers. Some of this was due to the large exposure to housing and housing-related businesses. Other issues centered around the State’s legislative processes. For instance, California has significantly less flexibility relative to other states when it comes to budgeting and raising revenue. Approval of two-thirds of the legislature is required to pass a tax hike. Additionally, the tax structure in California is highly progressive, taxing capital gains at the same rate as other income. As a result, a large portion of the taxes received are paid by a small portion of high-income taxpayers, which is a problem exacerbated in down economic times.

Aside from general improved economic performance, one of the issues that gave our credit analysts additional comfort with the state was the willingness of the legislature to address income tax volatility. Lawmakers, led by Governor Brown, helped to create a rainy day fund and passed several iterations of pension changes including increasing the retirement age and a new bill this June that proposes to fully eradicate the plan's unfunded liabilities over the next 30 years.

According to Moody’s and the California State LAO (Legislative Analyst Office), the fiscal year 2015 budget has revenues of $105 billion, spending of $107.9 billion, a prior year surplus of $4 billion and ends the fiscal year 2015 with a reserve of $0.5 billion and a deposit of $1.6 billion into the proposed new Rainy Day Fund. This is much improved from past fiscal years when there was no positive fund balance at all. Additionally, the State will be able to eliminate deferrals made to schools in prior fiscal periods and payback deficit funding done in recent years.

Our Portfolios

Due to its sheer size and demand for the credit, even at A1 levels, the State bonds were always trading well through (yielding less than the index) the Municipal Market Data (MMD) scale, showing how in demand they were. With a newly minted upgrade and the possibility that the Aa3 rating may now fit in more portfolio manager’s investment parameters, we expect demand to drive up near-term prices until the market can figure out the appropriate levels for secondary market offerings. SEI Fixed Income Portfolio Management retains California credit and its associated entities as continued “buys” in our portfolios.
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