

# California bonds looking a bit more appealing

By Kelly Nolan, Wall Street Journal

California has long ranked second only to Illinois in the dubious honor of being the least-loved state among municipal-bond investors.

But since Election Day, some investors have had a change of heart.

On Nov. 6, California voters approved temporary tax increases that Standard & Poor's estimates will boost the state's revenue by more than \$6 billion over the next several years. The tax rise was a controversial move in the already high-tax state, but it suddenly made California's bonds more appealing, market participants said. California also passed modest pension changes this year.

Meanwhile, Illinois has done little to address its \$83 billion unfunded pension liability. The state had roughly \$6 billion in unpaid bills as of the end of September, according to the state comptroller's office.

That has separated the two states in the minds of some investors. The difference in yield, or spread, between the debt of the two lowest-rated states has increased to its widest point since early March 2011, according to Thomson Reuters Municipal Market Data.

Last week, the yield on 30-year Illinois debt was 0.60 percentage point above that of similar California debt. As prices fall, yields rise. The higher the yield, the bigger the perceived risk. On Election Day, the spread was 0.42 percentage point. In July, it was 0.18 percentage point.

“Over the past year, California has done much more than Illinois to help its fiscal situation,” said Tom Weyl, head of municipal research at Barclays. As a consequence, “there appears to be decoupling” in the way the states’ bonds are trading.

California’s debt has rebounded so much that its yields this month fell below that of Nevada for the first time since August 2009, according to MMD.

In November, California munis have returned 1.50 percent through Friday, according to S&P Dow Jones Indices, compared with 1.43 percent for Illinois. For 2012, S&P Municipal Bond California index has returned 9.80 percent, while the Illinois index has returned 9.78 percent.

Both states are outperforming the broader muni market, as investors hunt for extra yield amid rock-bottom rates in markets such as Treasury bonds. The S&P National AMT-Free Municipal Bond index has returned 1.32 percent in November and 7.88 percent so far this year, through Friday.

The passage of the tax increase, under Proposition 30, was the “catalyst for this rally” in California bonds, said Dan Berger, MMD’s senior market strategist.

Investors are favoring California debt, even though S&P and Fitch Ratings give the Golden State the lowest rating of all 50 states, at A-minus, while Illinois is rated a notch higher, at A. Moody’s Investors Service gives Illinois the lowest state rating at A2, while it rates California a notch higher at A1.

“The market is signaling California has a better chance of getting upgraded, while Illinois may see a downgrade,” said Cynthia Clemson, vice president and co-director of municipal investments at Eaton Vance.

John Flahive, director of fixed income at BNY Mellon Wealth

Management, said his firm has bought more California bonds in light of Proposition 30's passage, while keeping exposure to Illinois debt steady. "Illinois has to make some fiscal changes....California can grow their way out of the problem," said Mr. Flahive, whose firm oversees about \$22 billion in munis.

To be sure, California still faces challenges, market participants say, and the tax increase voters approved this month is only for seven years, meaning a more permanent solution must be found to mend the state's budget woes.

Robert Donahue, managing director at research advisory firm Municipal Market Advisors, said investors should be leery of California's boom-and-bust economy, as well as its more tenuous cash position. The state's current cash deficit stands at \$24.7 billion, covered with \$14.7 billion of internal borrowing, and a \$10 billion short-term debt deal from earlier this year, he said.

"Things can change relatively rapidly," especially if there is an event that hinders the state from selling short-term debt, Mr. Donahue said. California is "lucky Proposition 30 passed, because if it didn't, we'd be having a different conversation right now."

Eaton Vance's Clemson said her firm is keeping its holdings of California bonds steady, while it has avoided buying Illinois's general obligation debt. With Illinois, "we are waiting for them to signal they are serious about fixing their problems," she said. With California, "I'd prefer to see them come up with more permanent budget solutions."