APPLETON PARTNERS, INC.

CALIFORNIA: CREDIT REFLECTIONS AS A NEW ERA APPROACHES

WHERE THEY WERE

As California Governor Jerry Brown winds down his last term, we look back at where the State stood prior to his most recent election in 2010. Since that time, California has turned a $25 billion deficit at the depths of the Great Recession into what is now a projected $8.8 billion surplus and enjoyed a resurgence in its credit standing amidst an eight-year economic expansion. ***Reflecting on what we saw at the time, how the recovery played out, and what we are looking for when evaluating tax-exempt issuers offers valuable insight into how we approach credit analysis.***

Heading into 2009, California faced a deteriorating national economy, growing unemployment, sharply falling home prices, and a considerable drop in tax revenue. Exacerbating matters was a lack of fiscal discipline, as the State historically spent at a greater pace than revenues could support. In response to $100 billion of cumulative deficits over fiscal years 2009-2011, the legislature had been largely reliant on one-time "fixes". In fact, the Department of Finance estimated that 80% of the gap-closing measures adopted in those years were temporary.

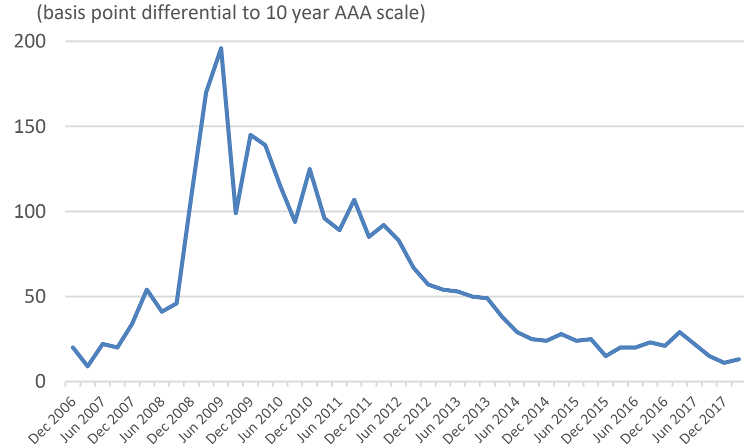
The State's budget imbalance ballooned accordingly, negatively impacting California's credit rating and repricing their debt.

California GOs were trading at historically wide spreads by mid-2009, reaching almost 200 basis points cheaper than pure AAA-rated names.

Weighing very heavily that summer was a cash shortfall that created an inability to pay bills out of operating revenue, thereby prompting the issuance of registered warrants, or IOUs, to pay vendors. These were utilized for short-term cash preservation, as IOUs freed up funds to pay for the State's top priorities - constitutionally mandated educational spending and debt service payments. As an illustration of California's liquidity concerns during this prolonged period, GAAP-basis available fund balances declined from $673 million in fiscal 2006 to a negative $20.3 billion by fiscal 2011.[1]

Compounding the State's challenges were structural impediments to a balanced budget. They included the requirement of a two-thirds majority to pass a budget or raise taxes, a high percentage of constitutionally mandated spending, restrictions on property tax increases, and a preponderance of governing by ballot initiatives.

California General Obligation Bond Spreads
(basis point differential to 10 year AAA scale)



Source: Thomson-Reuters

WHY WE MAINTAINED OUR CONVICTION

Amid the credit storm marked by extensive spread widening, we believed that a buying opportunity existed, not only for California clients, but also national ones. What did we see that provided confidence in the State's GOs, and how does this relate to our investment process? ***Value in our eyes was largely a function of market incentives, legal standing, the State's economic base, and what ultimately proved to be political and popular will, all of which factor into long-term creditworthiness.***

Our first consideration was driven by powerful incentives. ***California, the largest and most frequent tax-exempt issuer, had a critical need to access the capital markets*** for short term operations and long-term capital projects. A debt default would not only impair their ability to come to market, it would have sharply raised borrowing costs, further straining the State's finances while also introducing political consequences.

By California law, debt service is second in priority only to Proposition 98 mandated educational spending. Looking back on the Fiscal 2010 budget, 40% of the State's revenues were directed to education, leaving about $53 billion to cover debt service payments of $5.7 billion. This represented only 11% of post-education resources, or 6% of total revenue, thereby affording policymakers greater flexibility than perhaps headlines suggested.

Economic breadth and tax base resiliency are always important credit risk considerations, particularly during times of economic strain. Despite recession, ***California's economy remained large and diverse, providing officials with an ample resource base to manage budget choices, and greater flexibility to implement badly needed reforms.***

In addition, given its large population, considerable wealth, high tax rates, and historically wide spreads, we anticipated that investor demand for California paper would remain steady. In fact, influenced by these considerations, the State's debt began attracting strong cross-over demand.

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REPAIR AND REVIVAL

As sharply as California's economy and credit profile declined, it subsequently rebounded just as strongly. Since 2010, economic activity, job growth and wealth creation have outpaced the nation, led by cyclical sectors such as technology, financial services, and construction.

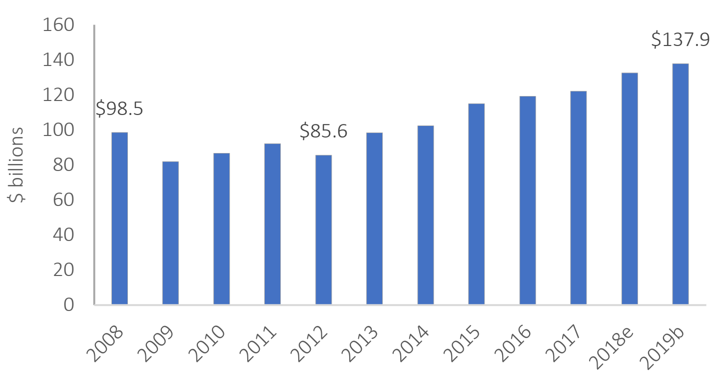
After declining by 4.1% in the depths of the recession, California's GDP has grown on average by 2.8% since 2010, well above national levels. Wealth creation has followed suit, with per capita personal income growth of 34.5% since 2010, as compared to 25.1% nationally.[2]

While a progressive tax structure and reliance on high-income earners led to significant declines in tax revenues during the recession, the opposite was true as the economy recovered and high paying jobs were added. General fund revenues increased by 5.6% and 6.4% in 2010 and 2011. After a decline in 2012 due to expiring temporary taxes, revenues resumed their growth in 2013, increasing by an average 7.5% through fiscal 2017.[3]

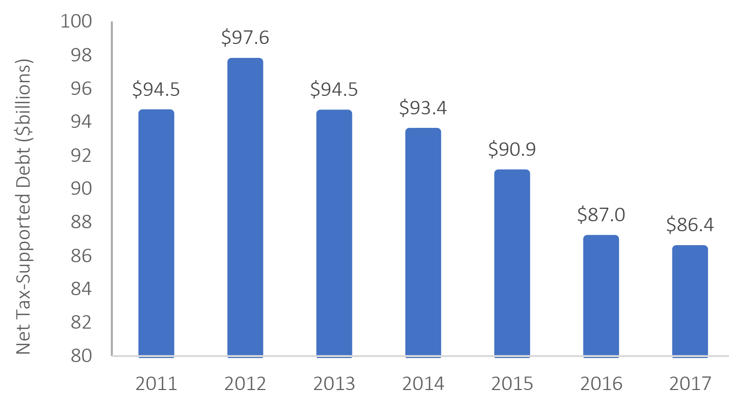
The State's credit standing greatly benefited from spending constraint, prudent management, and voter support for measures that enhanced budget flexibility. These are elements of fiscal stability we highly value when assessing issuers, as policymakers have limited control over cyclical economic conditions.

Complementing a resurgence in revenue with sustained spending controls has been instrumental to California's credit improvement. Governor Brown throughout his eight-year term has been steadfast in limiting spending growth and using tax revenue "windfalls" to pay down debt and increase reserves. The State now expects to boost its 2019 rainy-day fund to $13.5 billion, which would hit the cap of 10% of revenues one year earlier than forecasted. With debt payments recently exceeding new issuance, California has been able to deleverage, with net tax-supported debt declining from $97.6 billion in 2012 to $86.4 billion at the end of 2017.

General Fund Revenues March Upwards



California's Debt Continues to Decline



Source: Governor Brown's Budget Proposal - May 2018 Revision

Voters also played a role in the State's turnaround by approving ballot measures that increased tax revenues, facilitated passing budgets in a timely manner, helped build reserves, and curtailed lawmakers' ability to expand spending with non-recurring revenues.

Ballot Measure	Approval Date	Purpose	Impact
Proposition 25	November 2010	Changed budget adoption approval to simple-majority from super-majority	Streamlined budget adoption process, reduced pattern of late budgets
Proposition 30	November 2012	Temporarily increased sales tax rate through 2016 and income taxes for high earners through 2018	Provided $6 -$8 billion of additional revenues
Proposition 2	November 2014	Requires 1.5% of revenues and "excess" capital gains income be deposited into budget stabilization account	Enforced reserves and reduced lawmakers' ability to increase spending based on non-recurring revenues
Proposition 55	November 2016	Extended Prop 30's higher income tax rates through 2030	Avoided a steep drop in revenues, allows for increased education funding

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THE MARKET RESPONDS

As California was repairing its credit profile, investors reacted favorably. Reduced issuance, growing wealth creation, and higher personal income taxes all boosted demand for the State's paper. Spreads on California's GOs steadily tightened, with 10-year 5.0% coupon GO bonds now pricing at 5-10 basis points above the AAA scale. This marks a significant change from a peak of nearly 200 basis points in June 2009. The credit rating agencies also cast favorable judgment by steadily increasing the State's debt rating.

Date	Moody's	S&P
1/1/2009	A2	A+
2/2/2009		A
7/14/2009	Baa1	
1/13/2010		A-
4/16/2010	A1*	
1/31/2013		A
6/25/2014	Aa3	
11/5/2014		A+
7/2/2015		AA-
5/15/2018	Aa3	AA-

* recalibration
Source: Standard & Poor's, Moody's Investors Service

INVESTMENT IMPLICATIONS

California currently rests in a highly favorable position, with much lower borrowing costs and upgraded credit ratings. Investors holding the debt through the darker days of nearly a decade ago have been richly rewarded. What have we learned and how does this factor into our tax-exempt investment process?

While economic conditions are always a driving force, the California experience over the past decade also speaks to the importance of strong executive leadership and political will in financial stewardship. In what may be the later stages of a long economic expansion, California is now anticipating a transition in leadership. Restricted by term limits, Governor Brown is in his last year of office. ***We will carefully assess the extent to which fiscal prudency, a hallmark of the Brown years, is maintained by whomever takes the oath of office in January.*** How the new administration manages rising educational costs, Medicaid liabilities, and pension obligations will be telling, as will the Statehouse and Legislature's reaction to external influences such as the impact of tax reform on high-tax states, immigration, healthcare and the environment.

Fundamental credit analysis and qualitative assessment of executive and legislative policy are integral to our assessment of credit risk. ***Elements we emphasize include an issuer's tax base, revenue volatility, the influence and performance of key economic sectors, debt service burden, and executive and legislative asset and liability management.*** These all proved to be prominent factors in California's credit resurgence.

Of course, value is also a function of how the market is pricing a bond at a given time. A creditworthy issuer may not correlate with an attractive bond issue. That's why our investment process seeks to incorporate deep credit analysis, including proprietary issuer specific ratings and outlooks, as well as relative value assessment. As experienced with California GOs, adding value for clients demands understanding both the credit story and how a bond is trading.

1. "California", Moody's Investors Service, Emily Raimes, July 25, 2012
2. U.S. Bureau of Economic Analysis
3. California Department of Finance

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