APPLETON PARTNERS, INC.

CALIFORNIA CREDIT BRIEF

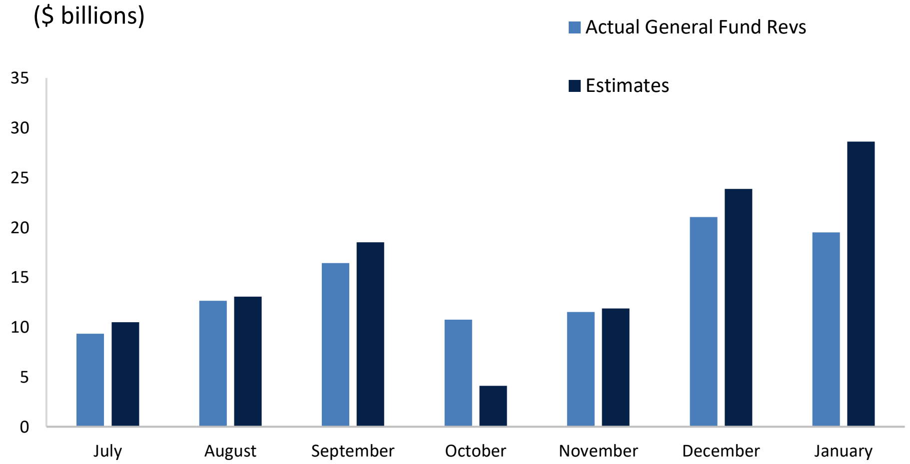
MARCH 1, 2023

The Golden State is Forced to Confront Fiscal Challenges

Persistently tightening monetary policy and a slowing economy have begun to work their way into state tax revenue collections. Across the nation, median growth in monthly revenues slowed from double-digit levels early in 2022 to low-single digits by year-end. **While most states have faced tax revenue pressures, California is facing more acute revenue deterioration.**

The State brought in $101.2 billion of tax revenue over the first seven months of the current fiscal year (measured through January 2023), down $22.9 billion in absolute terms and 18.5% year-over-year. Budget officers had prudently anticipated a slowdown, but not one of this magnitude, as revenues are underperforming an already lowered forecast by 8.4%. California's recent fiscal trendline lags most other states and is driven by several defining factors, most notably a progressive tax structure, reliance on a relatively concentrated population of wealthy taxpayers, a surge in technology industry layoffs, and above average exposure to capital gains taxes. The State's tax revenues are notoriously sensitive to economic swings in both directions, and we expect revenue to underperform peers over the near-term.

California Monthly Tax Revenues ($ billions)



Source: California State Controller

Credit Ramifications Should Be Modest

Tax revenue headwinds and the likelihood that upcoming April collections will also disappoint have made it increasingly likely that California will face a deficit over the course of the fiscal year ending on June 30, 2023. We expect that Governor Newsom's projected FY 2024 deficit of $22.5 billion will prove to be an underestimation, and as a result the State is likely to tap reserves and cut expenses to cover a sizeable two-year fiscal shortfall. Measures of this nature are entirely appropriate, although reserves will decline accordingly, and some services will need to be scaled back. Although the State's fiscal profile will inevitably be impacted, rating pressure should be limited.

Our research team believes California has the tools needed to weather a downturn without significantly weakening its credit standing. Our confidence is based largely on State reserves in excess of $30 billion, an ability to curtail significant one-time spending, and improved budgetary mechanisms, all of which offer the flexibility to navigate revenue underperformance.

Post-Crisis Budgetary Reforms Should Prove Beneficial

Tax revenue volatility remains a credit overhang for California, although budget reforms implemented in the post-Great Financial Crisis years bolster our confidence in fiscal management.

- Prop 25 (Nov. 2010) – A simple majority is now needed to pass a budget, rather than the burdensome 2/3 super-majority previously required. California's Democratic Legislature and governorship also reduce the risk of protracted negotiations and should help streamline budget adoption.
- Prop 25 (Nov. 2010) - Legislators do not get paid if a budget is not passed by June 15th, creating strong incentives to pass a bill. By comparison, the State did not have a budget in 2008 until September, three months into the fiscal year. By that point, the spending plan had already grown stale in the face of a declining economy, and only three months later the budget gap had already ballooned to $15 billion.
- Prop 2 (Nov 2014) - A constitutional requirement that excess capital gain revenues realized during "good times" be added to reserves has facilitated building a very sizeable cushion that can be drawn upon when revenues underperform. The provision also reduces lawmakers' ability to tie volatile or non-recurring revenue growth to increased long-term spending.

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Investment Implications

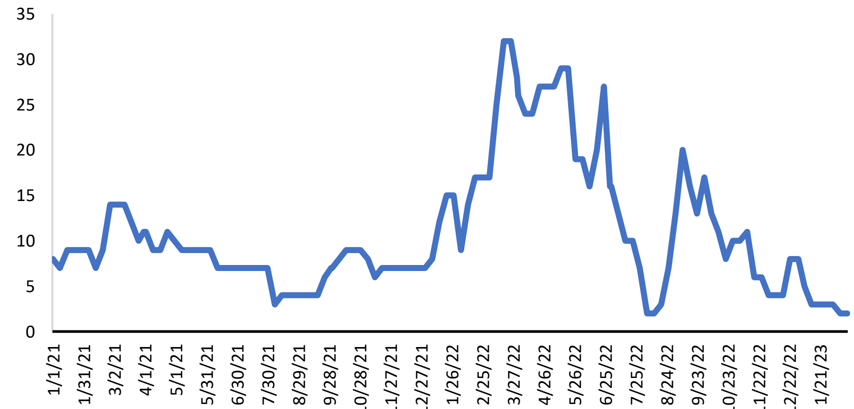
The State of California's credit fundamentals are weakening, and we acknowledge that there is modest downgrade risk. However, we remain confident in the State's credit standing for the reasons outlined in this brief. Furthermore, General Obligation bonds continue to trade well, supported by strong technical demand for in-state tax-exempt paper and strong liquidity.

We are monitoring fiscal developments in California, although we do not currently anticipate major changes in client portfolios. Nonetheless, the current environment is leading us to selectively seek out value opportunities based on individual client circumstances.

For example, non-California clients for whom we purchased California GOs at attractive spreads have likely seen those levels get richer over time and may now be able to benefit from reallocating into other bond issues.

As always, our portfolio managers and traders are evaluating such relative value situations with careful consideration of tax implications, strategy and account specific portfolio construction parameters, and reinvestment opportunities in a supply constrained market.

California GOs: 10-year Spreads vs. AAA (basis points)



Source: Refinitiv MMD

Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and also invite you to reach out to us directly and/or visit www.appletonpartners.com/Insights for additional commentary and insights.

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