California Overview
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INVESTMENT COUNSELORS SPECIALIZING
IN TAX-EXEMPT MUNICIPAL SECURITIES

C.W. Henderson and Associates believes that the credit quality of the State of California remains adequate but may deteriorate in the near term, primarily driven by imbalanced operations. Any weakness in the state's financial position has the potential to negatively impact local communities, particularly school districts that may face delayed or reduced State funding payments.

California's Current Financial Position

As of the end of the 2016 fiscal year the State boasted a positive General Fund balance. This is the first time that the State has recorded a positive fund balance in more than ten years and represents a marked improvement from the State's weakest financial position in CY 2012, when its General Fund balance stood at a negative 26% of total revenue.

The State's largest source of revenue is its personal income tax which represents 46% of total revenues. Intergovernmental revenue, received predominantly from the federal government, accounts for 42% while sales taxes comprise the remaining 12%. For the current fiscal year the State forecasts a slight increase in sales tax receipts and no growth for income tax and intergovernmental revenues. Those projections for State receipts are 2% lower than previous estimates.

The State's largest expenditure is Health and Human Services (Medicaid), which represents 52% of total expenditures. Education comprises 32% of total expenditures and is the State's second largest expenditure. For the current fiscal year the State forecasts total expenditures to grow by 2.5% over previous projections, including 4% growth for Medicaid and 2% growth for education.

As of June 30, 2016, the State's largest pension system, the State Teacher's Retirement System, was 63% funded. Total pension, other post-employment benefits and debt service costs aren't overly burdensome, accounting for 10% of total expenditures. Recently passed legislation will increase pension contributions for most state-wide participating entities, with school districts bearing the bulk of the burden.

Current and Projected Budget Deficits

Deficit projections for the current fiscal year come in between $400 million to $1.6 billion and represent roughly 1% of total revenues. Additionally, budget estimates for the upcoming fiscal year forecast another deficit. The projected imbalances are being driven by flat-to-possibly declining income tax revenues coupled with growth in the State's Medicaid system.

Declining income tax revenues have been largely driven by declines in the State's capital gains tax receipts. Such receipts account for 10% of the State's overall revenues and have declined by more than 7% over the past two years. California's reliance on this revenue source has long made the state susceptible to the variability of market conditions. As a result any economic downturn is expected to negatively impact the State's overall revenues.

Increased State expenditures are largely a result of the tremendous growth in the State's Medicaid system. Since the passage of federal healthcare reform in 2010, California's Medicaid system has seen substantial enrollment participation, including a 14% increase between 2013 and 2016. Current estimates suggest that one in three Californians are enrolled in the State Medicaid system. Any federal funding reductions to Medicaid would have a substantially negative impact on the State's financial position.

Governor Brown has proposed reductions in State revenues for local school districts and state universities to address the referenced budget imbalances. In the past the State has pursued a similar strategy to address such deficits. The reductions in State revenue, combined with rising pension costs, are expected to have a disproportionate impact on financially weaker school districts that rely heavily on state funding.

Conclusion

At C.W. Henderson we believe that the state of California's financial position remains adequate although the potential exists for some financial deterioration in the near term. Heavy reliance on personal income tax revenues leaves the state vulnerable to an economic slowdown. Proposed reductions in federal funding for the State Medicaid system could increase budget shortfalls. At the local level school districts that are already heavily reliant on state support would be impacted the most by reduced state funding. The finances of local school districts may also be further stressed due to state mandated increases in pension contributions.

C.W. Henderson invests in numerous local California credits. Our analysts perform regular reviews on all bonds that we purchase and pay close attention to topical issues that may directly or indirectly affect the credits in our portfolios. We emphasize high credit quality and are quick to pro-actively liquidate positions that do not meet our investment criteria.