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RESEARCH PAPER | AUGUST 2026

California Credit: **Looking Beyond the Headlines**

Assessing California's Long-Term Credit Fundamentals

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Executive **Summary**

One year ago, California's credit outlook was overshadowed by concerns surrounding tariffs, slowing capital markets activity, federal policy uncertainty, and widening projected budget deficits. Our view at the time was that markets were placing too much weight on near-term fiscal weakness and not enough on the state's underlying fundamentals: a broad and diversified economy, substantial financial flexibility, and an established fiscal framework.

Developments over the past year largely reinforced that assessment. Revenue collections exceeded prior projections by approximately $16.8 billion[1], driven primarily by stronger-than-expected personal income tax receipts, particularly capital gains and stock-based compensation from California's technology sector. Combined with continued economic growth and improving pension funding, California enters fiscal 2026-27 from a stronger fiscal position than appeared likely a year ago, and its general obligation ratings, Aa2/AA-/AA from Moody's, S&P, and Fitch, respectively, remained unchanged.

We view the improved budget picture as encouraging, but not as evidence that California's longer-term credit profile has fundamentally changed. The state's structural strengths remain intact, but so do its structural challenges. The lesson of the past year cuts both ways: just as markets risked overreacting to deteriorating budget headlines last year, they risk overreacting to improving ones today.

[1] Reflects the upward revision to GF revenues in the Governor's 2026-27 May Revision relative to the January Governor's Budget forecast, measured across the three-year budget window (fiscal years 2024-25 through 2026-27). Source: California Department of Finance, 2026-27 May Revision, Revenue Estimates.

Revisiting Our View

Last year, we argued that the market was overweighting California's near-term fiscal pressures while underappreciating the state's underlying credit strengths. We did not dismiss the state's structural challenges; rather, we cautioned that near-term pressures, including tariffs, federal policy uncertainty, etc., were magnifying them, making the budget picture appear worse than the state's fundamental credit quality warranted. Over the past year, that view was largely borne out. California maintained stable high-grade ratings, revenues significantly outperformed expectations, and financial flexibility improved meaningfully. Although we anticipated resilient tax collections, the magnitude of the surprise exceeded our expectations as gains in technology equity values and stock-based compensation drove a sharp increase in personal income tax collections.

While IPO activity itself is not a primary direct driver of state revenues, broader capital market performance remains important given California's reliance on personal income taxes from high earners, including capital gains and stock-based compensation.

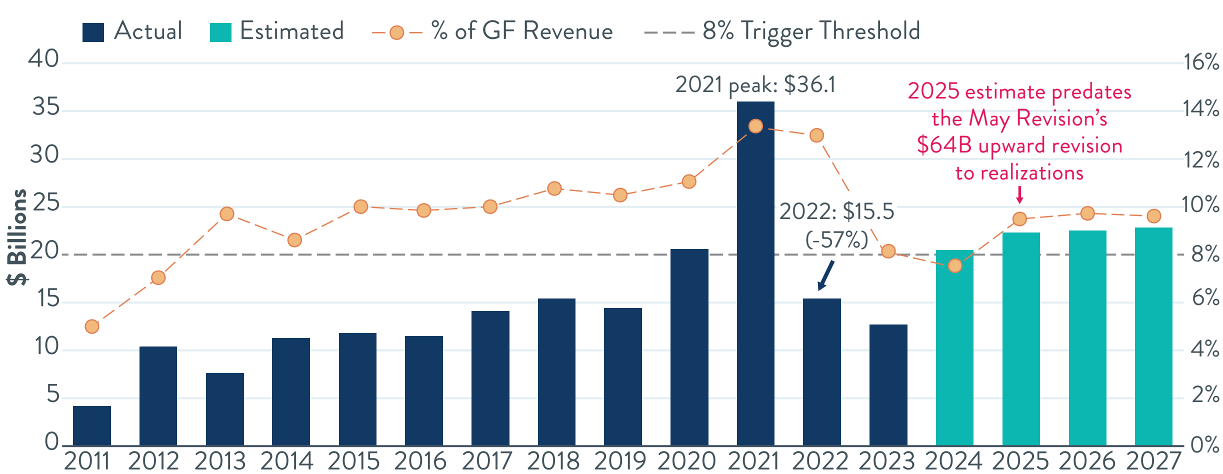
Nevertheless, the central distinction that mattered then still matters now: whether developments represent transitory shifts or lasting changes to the state's structural credit profile.

Current Credit Assessment

The enacted 2026-27 budget totals $351.7 billion in total state spending across the General Fund (GF), special funds, and selected bond funds, including $251.5 billion from the GF. The plan reflects stronger-than-expected revenue collections that provided meaningful flexibility while alleviating near-term budget pressure. More

Figure 1: Personal Income Tax Revenue From Capital Gains

Calendar years 2011–2027, $ Billions; 2024–2027 estimated (January Governor's Budget)



Note: Capital gains realization bars are shown on a calendar-year basis; Prop 2 revenue percentage is shown on a fiscal-year basis and is therefore offset by approximately six months.

Sources: California Department of Finance, 2026-27 Governor's Budget (Prop. 2 exhibit). Personal income tax attributable to capital gains, calendar year.

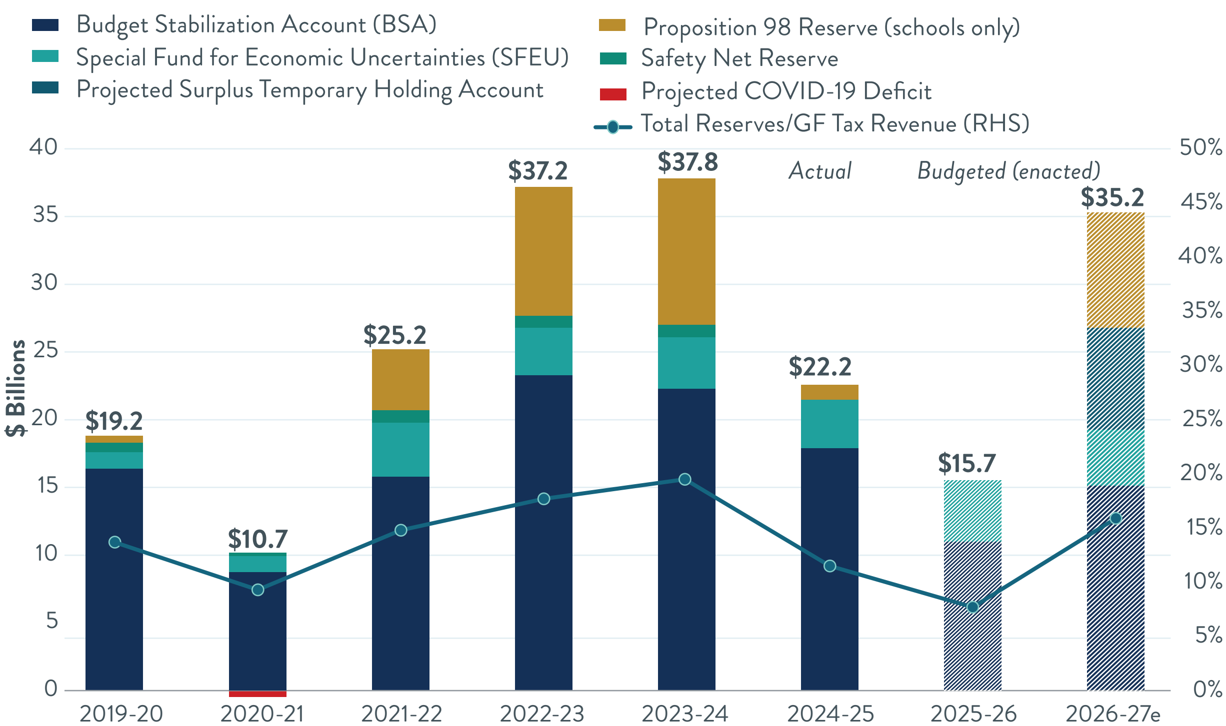
importantly, policymakers have begun shifting their focus from simply balancing the current budget toward strengthening California's long-term fiscal framework. That shift is particularly noteworthy because California's greatest fiscal challenge has never been balancing a single year's budget, but rather managing one of the nation's most volatile revenue structures across an economic cycle.

Financial Flexibility

California's reserve position strengthened considerably beginning in FY 2021-2022 and remained strong even as budgetary pressures subsequently emerged, though the headline figures masked an important shift in reserve composition. As Figure 2 shows, total reserves increased from $25.2 billion in FY 2021-2022 to $37.2 billion in FY 2022-2023 and peaked at $37.8 billion in FY 2023-2024. Importantly, however, the composition of that final increase differed from the earlier reserve buildup.

Figure 2: California Budget Reserves by Account

Fiscal years 2019-20 through 2026-27, $ Billions; actuals through 2024-25, budgeted thereafter



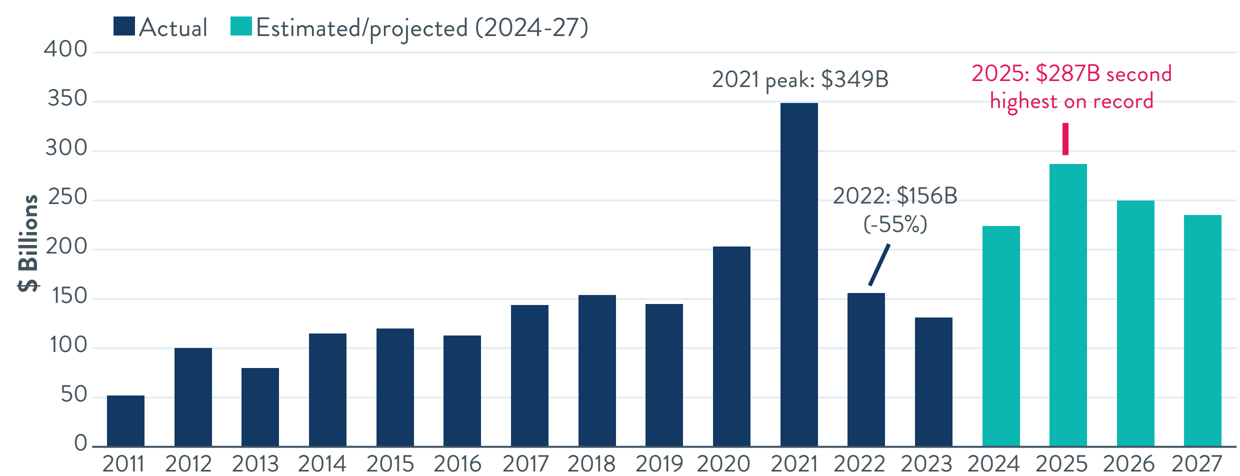
Sources: California Department of Finance (GF Condition Survey) and Legislative Analyst's Office Annual Spending Plans (2019-20 through 2024-25); enacted 2026-27 Budget Act (2025-26 and 2026-27). Reserve balances shown on a budgetary basis. Ratio reflects Total Reserves as a share of GF Total Revenue, excluding transfers.

Note: Reserve balances are shown on a budgetary basis; figures may differ from audited fund balances reported in the state's Annual Comprehensive Financial Reports. Total reserves include the Proposition 98 Reserve, which is available only for school and community college funding; general purpose reserves available for broader budget needs are correspondingly lower. The Projected Surplus Temporary Holding Account appears for the first time in 2026-27, reflecting its initial funding under the enacted budget; the account was established in 2024 but was not funded in prior years. The Proposition 98 Reserve rises sharply in 2026-27 as strong capital gains revenue triggers a large mandatory deposit, after being substantially drawn down during the intervening deficit years. The Safety Net Reserve was fully drawn down and is not rebuilt in the budget years. Figures for 2025-26 and 2026-27 reflect budgeted amounts and are subject to revision. The 2020-21 total reflects a $716 million expected COVID-19-related shortfall netted against reserve balances, as projected in the 2020-21 Budget Act.

The Budget Stabilization Account (BSA), the state's primary general purpose rainy day reserve, edged lower in FY 2023-2024 even as the headline total continued to rise. That final headline increase was driven largely by the Proposition (Prop) 98 Reserve, which is constitutionally restricted to K-14 education and cannot be used to address broader GF shortfalls. In other words, by FY 2023-2024, continued growth in headline reserves was masking a decline in the state's more flexible fiscal cushion.

That distinction is particularly important because budgetary pressures had already begun to emerge while headline reserves were still rising. Reserve balances do not necessarily move in tandem with the current year budgetary position, as deposits into the BSA and Prop 98 Reserve are partly formula driven and can reflect prior year revenue and capital gains performance. As those accumulated resources were subsequently drawn down, total reserves fell sharply, to $22.2 billion in FY 2024-2025 and a budgeted $15.7 billion in FY 2025-2026. The decline reflects the same capital gains volatility discussed below: the 55% drop in capital gains realizations following the 2021 peak (Figure 3) contributed to a string of projected budget deficits, leading the state to use reserves as part of its budget solutions.

Figure 3: California Capital Gains Realizations
Tax years 2011–2027, $ Billions; 2024–2027 estimated



Sources: California Department of Finance, 2026-27 May Revision, "Capital Gains Realizations Levels and as a Share of Personal Income." Total capital gains realizations, calendar year.

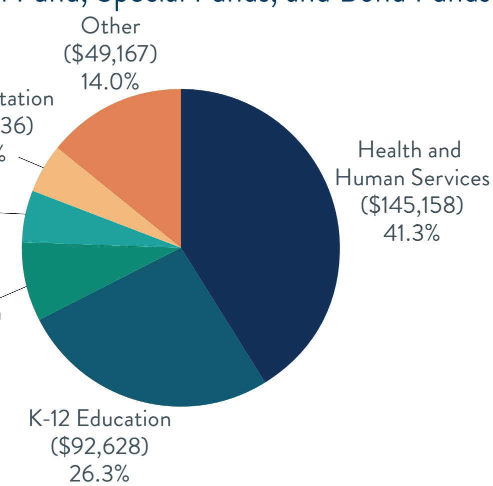
Reserves are budgeted to rebound sharply to $35.2 billion in FY 2026-2027, but the composition again matters. The increase is driven largely by a mandatory deposit into the Prop 98 Reserve triggered by strong capital gains revenue, a formula driven response to the 2025 capital gains surge rather than a comparable rebuilding of the state's more flexible general purpose reserves. The Safety Net Reserve, by contrast, remains fully drawn down and is not rebuilt anywhere in the budget window, leaving the state without that particular buffer heading into the next downturn, though the gap is tempered somewhat by the Projected Surplus Temporary Holding Account, where funds carry no restriction on use.

One of the more constructive developments is Assembly Constitutional Amendment 20 (ACA 20), which voters are expected to consider this November. The measure would incorporate the state's temporary surplus holding account into California's constitutional budgeting framework, complementing Prop 2's formula-driven reserve deposits by giving policymakers additional flexibility to set aside revenue during periods of exceptionally strong growth. Given California's heavy reliance on capital gains and other economically sensitive revenue sources, we view the proposal as incrementally credit positive. Larger reserve balances would improve the state's ability to absorb revenue volatility and reduce the severity of budget adjustments required during downturns. Notably, Moody's has cited sustained reserves in excess of 25% of revenue as a factor that could support upward rating momentum[2], underscoring the potential significance of a strengthened reserve framework.

Long-Term Liabilities

Long-term liabilities also continue to improve. CalPERS reported a preliminary 14.8% investment return for fiscal 2025-26, its strongest result in five years, lifting the system's funded ratio to approximately 85% from 79% a year earlier.[3] CalSTRS also posted strong results for fiscal 2025-26, announcing a 13.9% net investment return, nearly double its 7% target.[4] Based on this year's return, we would estimate the funded ratio has likely improved into the 80s, though the precise figure will depend on CalSTRS' asset smoothing mechanics and won't be confirmed until the next actuarial valuation. Pension funding will continue to fluctuate with financial markets, but these improvements strengthen the funded status of both of California's major

Figure 4: 2026-27 Total State Expenditures by Agency
Dollars in Millions; General Fund, Special Funds, and Bond Funds



Sources: California State Budget 2026-27 (enacted), "2026-27 Total State Expenditures by Agency." "Other" includes Legislative/Judicial/Executive, General Government, Natural Resources, Government Operations, Environmental Protection, Labor and Workforce Development, Housing and Homelessness, and Business and Consumer Services.

[2] *Moody's Ratings, "California (State of): Update to credit analysis," September 17, 2025.*

[3] *CalPERS, "CalPERS Posts 14.8% Preliminary Investment Return for Fiscal Year 2025-26," news release, July 2026.*

[4] *CalSTRS, "CalSTRS earns 13.9% net return, exceeds benchmark in fiscal year 2025–26," news release, August 4, 2026.*

pension systems, one of the state's most important long-term credit metrics. More broadly, California's leverage remains manageable: while the state carries the largest debt load of any state in absolute terms, long-term liabilities represent roughly 125%[5] of own-source revenue, moderately above the state median but well below the most heavily burdened states, with unfunded pension obligations, rather than bonded debt, comprising the largest component.

Structural Pressures

Several challenges remain despite the state's improved fiscal position.

As Figure 4 on page 5 illustrates, Health and Human Services alone represents $145.2B, or 41.3% of total state expenditures. It is the single largest budget category, one dominated by Medi-Cal, which magnifies the state's exposure to any change in federal health policy or funding. Costs in this area continue to outpace many other parts of the budget, and the enacted budget already appropriates additional GF resources to offset reductions tied to the One Big Beautiful Bill Act (OBBBA), including new spending associated with Medi-Cal eligibility changes. Federal funding reductions extend beyond Medi-Cal as well, touching nutrition assistance programs and other areas that could create additional pressure for future state backfill.

California's constitutional budgeting framework also shapes fiscal flexibility. Prop 98 dedicates a significant share of GF revenues to education, while Prop 2 directs portions of strong revenue growth toward reserves and debt reduction. These constitutional requirements promote long-term fiscal discipline, but they also mean that a meaningful share of revenue windfalls is committed before policymakers have discretion over how the funds are allocated.

Finally, recent budgets have relied in part on internal borrowing and other one-time budget solutions that will require repayment in future years. Combined with recurring wildfire response costs and continued stress in California's property insurance market, these obligations represent ongoing demands on future budget flexibility. Individually, none of these issues presents an immediate credit concern; collectively, however, they underscore that California's structural challenges have not disappeared despite the recent improvement in revenues.

Looking Ahead

California's near-term credit outlook has improved. Stronger revenues, healthier reserves, improving pension funding, and continued financial flexibility support our expectation of stable credit quality over the near to intermediate term.

Our longer-term outlook remains more measured for three reasons.

First, a meaningful portion of the recent revenue outperformance is attributable to unusually strong capital gains realizations and stock-based compensation generated during the current technology investment cycle. These have historically been among California's most volatile revenue sources; and we do not expect recent collections

[5] *Moody's Ratings, "California (State of): Update to credit analysis," September 17, 2025; leverage figures as of June 30, 2024 (most recent data available).*

to represent a new baseline, a view reflected in the state's own budget projections. Even after the recent revenue surge, both the administration and the LAO now project underlying structural deficits of roughly $10 billion annually through FY 2029-30[6], down sharply from the LAO's own $35 billion annual estimate as recently as November 2025[7]. That improvement is real, and it supports our near-term view that credit quality should remain stable. But a smaller structural deficit is not the same as no structural deficit: even under this more optimistic, post-surge outlook, revenues are still not projected to cover ongoing expenditures on a sustained basis. Today's revenue strength has narrowed California's structural imbalance, but it has not eliminated it.

Second, healthcare spending remains a persistent pressure. Beyond existing cost growth, further implementation of the OBBBA's federal healthcare funding reductions could require California to redirect additional GF resources toward Medi-Cal and related programs. The state has policy options available, but reduced federal support would incrementally erode budget flexibility if offsetting solutions are not identified.

Third, we are monitoring policy proposals that could influence California's longer-term economic competitiveness, including the proposed state wealth tax. The proposal remains preliminary, but California's dependence on a relatively small number of high-income taxpayers means policies affecting that population warrant close attention. At this stage, we view it as an issue to monitor rather than a material credit concern.

Conclusion

California's fiscal position is meaningfully stronger today than it appeared one year ago. Stronger-than-expected revenues, improving pension funding, and enhanced financial flexibility support our expectation that credit quality will remain stable over the near to intermediate-term.

Over a longer horizon, however, we continue to view much of the recent fiscal improvement as transitory rather than structural. California's long-term credit trajectory will depend less on another year of exceptional capital gains realizations and more on policymakers' ability to convert today's fiscal strength into lasting structural resilience through prudent reserve management, disciplined budgeting, and continued attention to long-term spending pressures.

Accordingly, we will be watching three developments closely over the coming year: the outcome of November's reserve amendment, the durability of capital gains-driven tax collections as the current technology investment cycle matures, and the state's response to reduced federal healthcare funding. Together, these developments will provide important signals as to whether California's recent fiscal improvement represents a temporary windfall or the beginning of a more durable credit profile.

[6] *Legislative Analyst's Office, "The 2026-27 Budget: Initial Comments on the Governor's May Revision," May 18, 2026, p. 9 (Figure 3). Figure reflects the administration's own estimate; LAO's independent revenue estimates yield a substantively similar result.*

[7] *Legislative Analyst's Office, "The 2026-27 Budget: California's Fiscal Outlook," November 19, 2025, p. 10.*

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