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CA CREDIT & THE RISK OF AN AI BUBBLE

AUTHORS



Adam Stern, J.D., M.P.A.
Co-Head of Research



Ruth Ducret
Senior Research Analyst

Key Takeaways

- California's fiscal resilience is supported by a historically strong general fund reserve position
- It's also helped by a lower bonded debt burden since 2012 and a lower net pension liability.
- The public power and local government sectors face risks from an artificial intelligence (AI)-driven economic correction. So do issuers with significant asset market exposure via endowments.



Gita Gopinath, a former International Monetary Fund (IMF) chief economist, recently estimated that an AI-driven stock market correction could reduce U.S. household net worth by \$20 trillion and U.S. gross domestic product (GDP) by 2 percent.¹

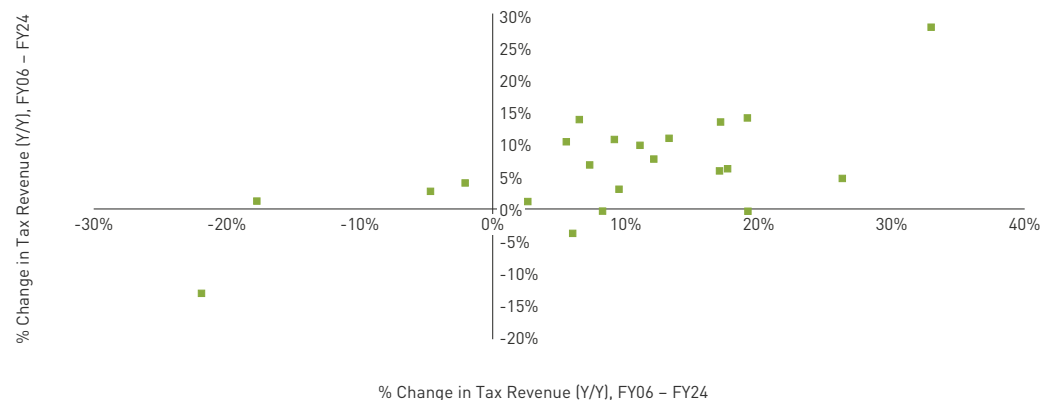
High-grade municipal bond portfolios typically weather equity market corrections ably. The essential service bonds that dominate the rated municipal market are backed by monopoly service providers and typically come with security pledges of unlimited taxes or rate hikes. Nearly 20 percent of the market is backed with credit enhancement.² Furthermore, investors in separately managed accounts (SMAs) have flexibility to hold their bonds to maturity if a correction weakens bond pricing or liquidity.

BUT WHAT ABOUT CALIFORNIA?

Nonetheless, investors with exposure to California municipal bonds — particularly those of the state — are reasonable in asking: “What happens to California’s credit fundamentals if the AI boom reverses?”

The State of California’s tax structure is notoriously volatile, as it is highly correlated with asset prices. Going back to 2006, a 10 percent change in the level of the S&P 500 is associated with a 4 percent change in state tax revenue (See Figure 1). This math suggests that an AI-driven 40 percent decline in stock prices could result in a 16 percent drop in tax revenue. Should tax revenues see a significant adjustment, California’s fiscal status could be challenged, given its high cost of living and already elevated tax burden relative to peers.³

FIGURE 1: CALIFORNIA'S TAX REVENUE IS CORRELATED WITH THE STOCK MARKET



Source: S&P 500 [average based on monthly levels for each year], Merritt Research Services and Breckinridge Capital Advisors, Inc., as of November 2025.

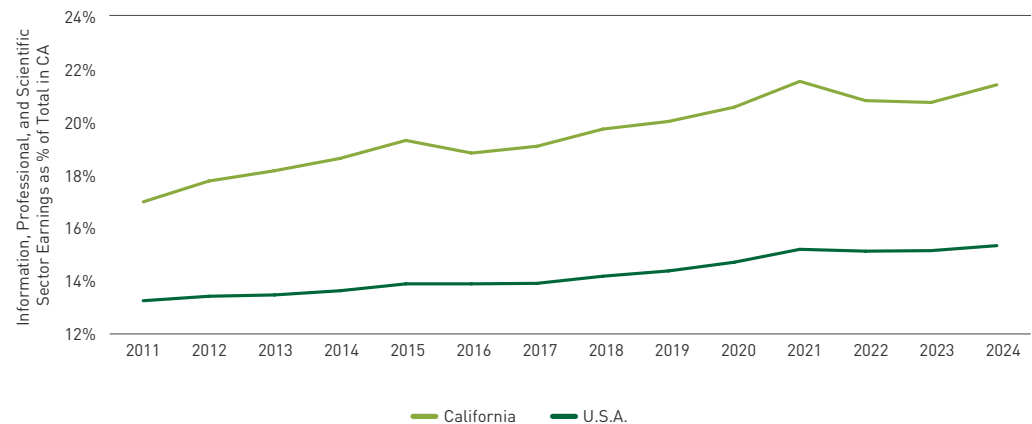
California’s tax volatility stems from its reliance on progressive income tax rates and its concentrated tax base. The state imposes a 12 percent marginal income tax rate on joint filers earning more than \$1 million.⁴ These taxpayers earn 22 percent of the state’s personal income but pay 39 percent of its personal income taxes.⁵ This approach to tax policy results in fiscal booms and busts, as nearly 60 percent of the state’s general fund comprises personal income taxes.⁶

1. “Gita Gopinath on the crash that could torch \$35 trillion of wealth,” Economist.com, October 15, 2025.
2. Breckinridge calculation based on Bloomberg data, October 2025. For these purposes, enhancement means a bond insurer or a state-based program.
3. The Tax Foundation ranks California 48th out of 50 states for tax competitiveness. See the [Tax Foundation’s 2025 Tax Competitiveness Index](#).
4. Tax Foundation data for calendar year 2025, rate applies to joint returns.
5. Further complicating matters, variable capital gains income comprises ¼ of these taxpayers’ total adjusted gross income. See: State of California adjusted gross income figures (2022), available through the state’s Franchise Tax Board, Table B-4a.
6. Per the state’s FY24 audit.



California's income tax base may also be more correlated with the fate of AI than it was a few years ago given the state's employment profile. AI employment is largely captured in the Information and Professional/Scientific sectors, per the Bureau of Labor Statistics. Payroll earnings from these sectors increased from 17 percent to over 21 percent of the California total (See Figure 2).

FIGURE 2: EARNINGS IN AI SECTORS HAVE GROWN



Source: Bureau of Labor Statistics and Breckinridge Capital Advisors, Inc., as of November 2025.

Additionally, the state's pension systems are exposed to an AI correction. California contributes to two major pension plans: CalPERS (for state employees) and CalSTRS (for teachers). Combined, public and private equity comprise 55 percent and 52 percent of each plan, respectively.⁷ At present, both plans are underfunded, despite recent equity market increases.⁸ The funds might experience weak returns if the market reassesses AI's value proposition.⁹ State contributions to the funds would subsequently rise.

Further complicating California's fiscal picture is a more uncertain and austere federal policymaking environment. Federal aid may be less likely to flow after a correction, as it did in 2001, 2007-09, or 2020, considering: Congress's struggle to pass a fiscal 2026 budget; Medicaid cuts scheduled for 2027 and 2028; and executive actions in 2025 that withheld federal aid to states for a mix of reasons.

HOW CONCERNED SHOULD CALIFORNIA INVESTORS BE?

In our view, a little. A California rating downgrade in the aftermath of a sharp market correction is very possible. Moreover, a significant degree of budget discipline over a multi-year period would be required to maintain the state's fiscal balance after a correction. Nonetheless, California's fiscal stress would likely prove far more manageable than during the post-2008 period. In our view, it makes just as much sense to consider AI's impact on other sectors and the economy as it does to worry about California.

7. Per pp. 127 and 145 of the state's FY24 audit.

8. For FY24, CalPERS has a 75% funded ratio, CalSTRS 77%.

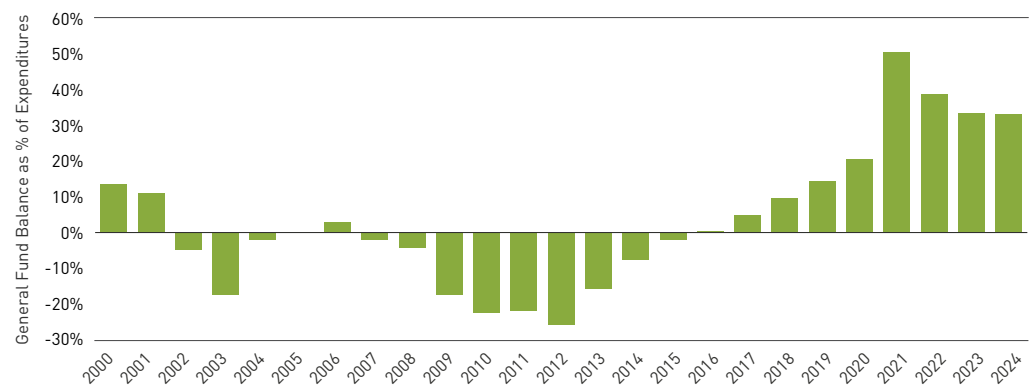
9. As of late October 2025, the combined market capitalization of the "Magnificent Seven" was roughly 35% of the entire S&P 500 index (Tesla, Meta, Amazon, Alphabet, Apple, Microsoft, Nvidia).



We note the following:

1. **The state is liquid.** California's tax collections exceed budget targets, year-to-date in Fiscal Year 2026 (FY26).¹⁰ Although the state plans to draw down reserves this year, the general fund's starting reserve position is in reasonable shape (See Figure 3). Outside of the general fund, California has over \$85 billion in borrowable resources, which it can use to lend to itself in a fiscal squeeze (an amount equivalent to 67 percent of budgeted general fund personal income taxes in FY26 and, 39 percent of general fund spending).¹¹ These figures suggest the state could likely avoid external deficit borrowing in the event of a correction. Additionally, rating agencies would likely give the state time to draw down reserves and to craft steps to rebalance operations before taking meaningful rating action.

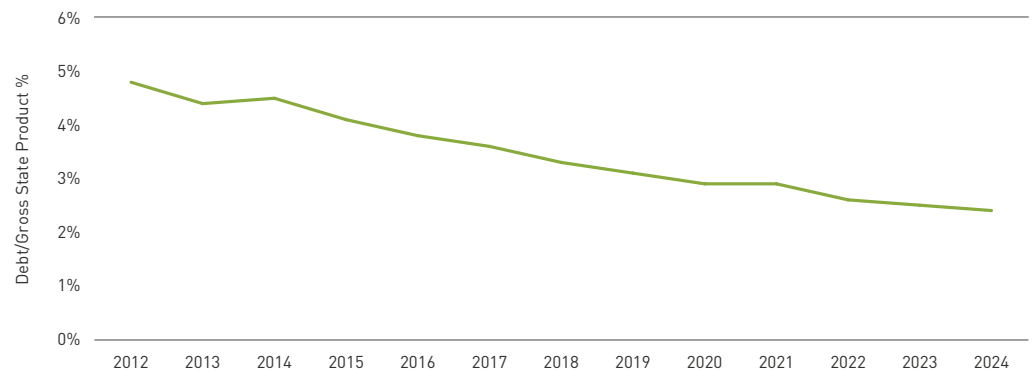
FIGURE 3: RESERVES ARE UP



Source: Merritt Research Services, Annual Comprehensive Financial Reports and Breckinridge Capital Advisors, Inc., as of November 2025.

2. **California's bonded debt burden declined in recent years.** Since 2012, the state's debt burden declined by 50 percent to 2.4 percent of gross state product (GSP). The falling debt load largely reflects policy changes (See Figure 4), growth, and inflation. Annual principal and interest costs currently comprise under 3 percent of all-funds expenditures, offering the state additional flexibility in an economic downturn.

FIGURE 4: CALIFORNIA'S DEBT BURDEN HAS DECLINED



Source: Merritt Research Services and Breckinridge Capital Advisors, Inc., as of November 2025.

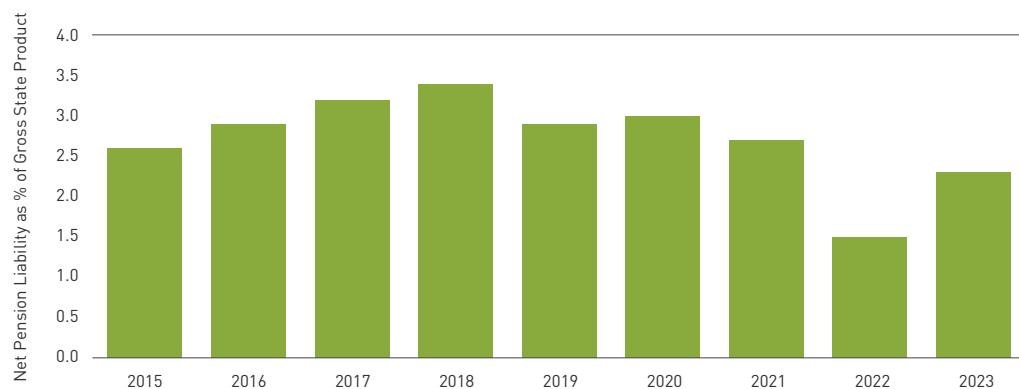
10. October 2025 Financial Bulletin, available through California Department of Finance.

11. September 2025 Statement of General Fund Cash Receipts and Disbursements.



3. **California's pension funding stability also improved.** The state's net pension liability has declined from 3.4 percent of GSP in 2017 to 2.3 percent in the most recent year (See Figure 5). In the event of a large correction in equities markets, contributions into each fund will rise, but they will do so on a smoothed basis, meaning they will be amortized and paid from the budget over a period of years.¹² Annual contributions for pension and retiree healthcare obligations were 4 percent of all-funds expenditures in FY24.¹³

FIGURE 5: CALIFORNIA'S PENSION BURDEN IS MANAGEABLE



Source: Merritt Research Services and Breckinridge Capital Advisors, Inc., as of November 2025.

4. **Fiscal governance has improved since the last recession.** Fiscal rules adopted in 2014 are a key reason reserves are up and debt is down. Voters amended the state constitution in that year to require annual transfers to the state's rainy-day fund and the prepayment of debt.¹⁴ In an AI-driven downturn, the state would likely avoid adhering to these rules, instead declaring an emergency and drawing down reserves. But the existence of reserves increases the likelihood that the state would rebuild fiscal balance with reasonable speed, which reduces the potential for meaningful ratings downgrades.
5. **Apart from credit concerns, we note that Breckinridge's actively managed SMAs are typically underweight California exposures relative to major benchmarks.** California bonds typically comprise 18 percent of intermediate municipal bond benchmarks. We aim for no more than a 5 percent California position in our intermediate strategies.¹⁵ Conversely, Breckinridge's California-biased muni accounts are rarely 100 percent invested in California munis. We consider our client's in-state marginal tax brackets when deciding whether to buy a California bond or an out-of-state security.

12. For example, CalSTRS amortizes gains and losses over three-year periods, p. EX-1-21 of October 2025 official statement.

13. Breckinridge analysis of FY24 annual financial statements.

14. Proposition 2.

15. Percentages reflect Breckinridge's intermediate composite and the Bloomberg Barclays Managed Money Short-Intermediate 1-10 Index on November 6, 2025.

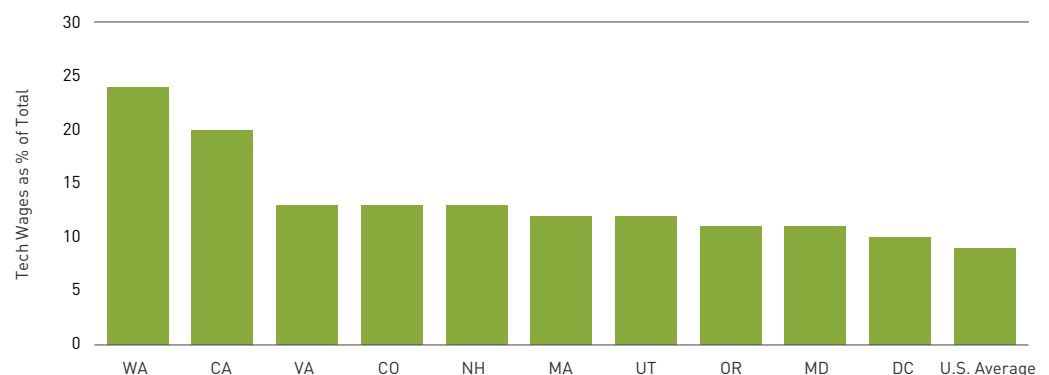


AI COULD IMPACT OTHER SECTORS & STATES, NOT JUST CALIFORNIA

If the state of California likely has the fiscal resources and tools to manage through an AI correction, to which sectors of the municipal bond market might investors in California (and elsewhere) pay more attention? At a high level, a few market segments come to mind:

- 1. Issuers with significant asset market exposure either via a pension or endowment.** Elevated pension contributions remain a credit albatross for some governments. Likewise, some hospitals and private higher education issuers rely, in part, on stock market returns to fund operations via endowments. These issuers may find an AI correction weakens their operating flexibility.
- 2. Public power.** Away from the stock market, AI has spurred a capital spending (capex) boom in data centers. These data centers require electricity, and some public power issuers could procure power (or generate it) with an intent to resell to data centers that are eventually found with overcapacity. This kind of stranded asset risk can lead to ratepayer revolts. For now, Breckinridge sees little evidence of this kind behavior in the utilities we cover but remains vigilant to this possibility.
- 3. Local governments with exposure to tech layoffs.** The AI transition may lead to significant net job losses in affluent knowledge-work regions. There are signs this is already happening in the tech sector, as AI replaces some software jobs. In addition to California, the states of Washington, Virginia, Colorado, New Hampshire and Massachusetts have meaningful exposure to AI-related employment disruption (See Figure 6). In our view, each of these states is, like California, reasonably well positioned to manage through such a transition. But specific localities within these states are likely to be more exposed, especially given that states typically reduce local aid in recessions.

FIGURE 6: AI-RELATED EMPLOYMENT DISRUPTION WOULD IMPACT KNOWLEDGE WORK ECONOMIES ACROSS REGIONS



Source: Bureau of Labor Statistics, Quarterly Census of Employment & Wages, Q1-2025 and Breckinridge Capital Advisors, Inc., as of November 2025.

"Tech" wages are the sum of private quarterly wages for (1) computer systems design and related services; (2) computer and electronic product manufacturing; (3) software publishers; (4) computing infrastructure providers, data processing, web hosting and related services; (5) media streaming distribution services, social networks and other media networks and content providers, and (6) web search portals, libraries, archives and other information services.

Breckinridge expects the deployment of AI-related technologies to have a meaningful impact on markets and the real economy over the next several quarters and years. The broad credit impacts are presently unclear. But we anticipate that our independent underwriting and ability to customize separate accounts may benefit clients in California and elsewhere, to the degree the economy transitions swiftly.



The content is intended for investment professionals and institutional investors.

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