ASSESSING THE IMPACT OF THE CALIFORNIA WILDFIRES ON MUNICIPAL BONDS

Our thoughts are with everyone affected by the Southern California wildfires, and to the first responders working under dangerous conditions to protect lives and contain the fallout. As the wildfires continue to impact Southern California, we are closely monitoring the situation and its potential effects on municipal bonds in the region. The insights shared in this article reflect our team's current understanding and analysis at the time of writing, recognizing that circumstances may evolve rapidly.

Key Takeaways:

- The Southern California wildfires are not expected to cause sustained credit deterioration in GW&K's municipal bond holdings.
- Federal, state, and insurance relief will likely mitigate financial disruptions.
- While there is no evidence linking its equipment to the fires at this time, the Los Angeles Department of Water and Power (LADWP) has a number of tools to address any potential costs.

WILDFIRE OVERVIEW

While the situation remains fluid, we do not anticipate material credit deterioration for our municipal bond holdings. We expect federal and state emergency relief programs, alongside insurance proceeds, to address cash-flow disruptions and physical damage.

By prioritizing large, diversified issuers with robust financial and operational frameworks, our portfolios are positioned to withstand catastrophic and weather-related events. We intentionally avoid more vulnerable credits, such as small cities and towns, tax-increment financings, and small single-asset borrowers that would be more susceptible to debt-service interruptions in the wake of large, climate-related events.

SECTOR ANALYSIS

General Obligation (GO) Bonds:

California GO bonds should see little impact from the fires. The state currently maintains a strong fiscal position, with FY 2025 reserves approaching 20% of expenditures. As the fifth-largest economy in the world, California's access to broad and diverse revenue streams provides stability against localized disruptions, even those as large as the present crisis.

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At the local level, Los Angeles County's GO bonds remain secure, supported by a $2 trillion tax base and a population of nearly 10 million. These factors provide a buffer against valuation impacts and population displacement. Smaller municipalities face far greater challenges under such circumstances. For example, the population of Paradise, California dropped from 26,000 to 8,000 after the 2018 Camp Fire.

Other GO credits in our portfolios, such as the Los Angeles Unified School District and Los Angeles Community College District, encompass similarly large areas and tax bases. These issuers benefit from unlimited tax levies that can be adjusted to ensure debt repayment and state funding that has historically remained stable during periods of distress.

Los Angeles Department of Water and Power: LADWP has drawn attention due to its proximity to the fire-affected areas. California's strict inverse condemnation law, which holds utilities liable for wildfire damages caused by their equipment regardless of negligence, creates potential risks. However, there is no evidence implicating LADWP equipment in the fires. In fact, several news reports suggest the only fire within LADWP's service area may have originated from an unrelated source along a hiking trail.

LADWP is the largest municipal utility in the country, serving nearly four million residents. It is important to remember that the utility is publicly owned and prioritizes service over profit. Its exposure to wildfire-prone areas is far smaller than that of investor-owned utilities (IOUs) in the state. With strong liquidity, rate-setting autonomy, and a large, diversified service area, LADWP is well positioned to manage potential liabilities.

Despite these strengths, S&P Global Ratings recently downgraded LADWP's electric division to A from AA-, citing the growing frequency and severity of wildfires in its service territory. The water division was also downgraded to AA- from AA+ following allegations in a lawsuit that its infrastructure servicing the Pacific Palisades area failed during the emergency. The downgrades, however, reflect precautionary concerns rather than any immediate financial distress and feel a bit heavy-handed given the acknowledgement that LADWP hasn't been implicated in originating the fires.

In contrast, Fitch and Moody's have opted for more measured approaches. Fitch kept LADWP's ratings at their current levels but placed them on Rating Watch Negative, indicating that there is a heightened probability of downward pressure. The agency, however, has indicated that it has no information suggesting municipal utility equipment ignited any of the LA fires and that an official determination could take weeks or months. It further noted that area issuers, including LADWP, could face increased costs but it's too early to determine the extent of any potential credit pressures. Moody's, which thus far has not taken any rating action, echoed a similar sentiment in recent commentary. It also theorized that the state could enact some form of legislative relief for publicly owned utilities in light of the recent devastation, particularly if any large liability is found.

Even if significant liabilities arise, LADWP has a number of tools to address potential costs. Unlike IOUs, LADWP benefits from full rate-setting autonomy, allowing it to adjust rates as needed without regulatory delays. It also has access to capital markets and the ability to issue bonds to address financial pressures. And as a publicly owned essential service provider, it is also likely to receive support from the state if extraordinary circumstances

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require intervention. Together these factors underscore LADWP's resilience and ability to remain operational while continuing to meet its debt obligations and other liabilities.

MARKET VOLATILITY

Natural disasters often lead to short-term market volatility, with spreads widening on affected credits due to uncertainty rather than fundamental deterioration. We have seen some regional issuers, particularly LADWP and some smaller related utilities, trade at wider levels since the fires began, but we view these moves as sentiment-driven, especially considering the retail nature of the municipal market.

CONCLUSION

We expect the combination of Federal Emergency Management Agency (FEMA) grants, state emergency relief funds, and insurance proceeds to address immediate operational and infrastructure needs. These measures, combined with the strong underlying credit quality of our holdings, support our view that the fires will not result in significant long-term impairments. By maintaining a disciplined focus on high-quality credits and diversified portfolios, we are well-prepared to manage volatility and adapt to evolving conditions. We will continue to monitor developments closely.

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