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MuniNotes
from our Credit Research Team

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LA wildfires leave municipal credit largely intact

One year after the devastating Los Angeles wildfires, municipal bonds remain stable despite property destruction. Meanwhile, California navigates AI-driven revenue volatility with stronger fiscal guardrails, while Chicago's contentious budget process exposes persistent structural challenges and mounting pension obligations threatening long-term financial stability.

HIGHLIGHTS

- **One year after the LA wildfires, municipal bonds show no defaults and modest assessed value declines, with tax bases expected to gradually recover.**
- **California's structural fiscal reforms since the dot-com crash provide stronger guardrails against revenue volatility from the AI boom.**
- **Despite a $45 billion revenue windfall, California's constitutional spending mandates offset gains; long-term structural imbalances require spending discipline and revenue increases.**
- **Five states may face a $10.6 billion social services freeze over fraud allegations, but the fiscal impact remains marginal given strong reserves.**
- **Chicago avoided a shutdown using one-time measures, but pension costs have surged 80% over 10 years, leaving structural deficits and unfunded liabilities unresolved.**

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LOS ANGELES WILDFIRES IMPACT MUNICIPAL CREDIT

One year after destructive wildfires burned 37,000 acres and destroyed over 16,000 structures throughout the Los Angeles metropolitan area, municipal credit remains intact. No bond payment defaults have occurred and assessed value declines have been modest, though the full impact of the disaster continues to unfold.

Some municipalities may experience minor assessed value reductions from property reassessments, but the impact remains limited. Santa Monica-Malibu Unified School District No. 2, for example, saw just a 0.4% year-over-year assessed value decline in FY26. As rebuilding advances and insurance claims process slowly, impacted tax bases should gradually recover.

Assessed value trends matter because they determine the tax levy pledged to General Obligation Unlimited Tax Bonds issued by cities and schools. Bondholders are protected from revenue shortfalls as tax levies can be increased to offset assessed value declines caused by wildfires.

Los Angeles Unified School District is rebuilding three fire-damaged charter schools. Impacted students attend classes at temporary on-campus facilities, and the state is expected to hold the district harmless for enrollment losses. Palisades High School will soon reopen using temporary portable classrooms, while two elementary schools will open with new facilities by late 2028. The district estimates $600 million in reconstruction costs will be initially funded with bond proceeds but ultimately reimbursed through insurance and FEMA grants.

Multiple lawsuits have been filed against the City of Los Angeles and Los Angeles Department of Water and Power (LADWP), including two class actions with one seeking over $10 billion in damages. The city and department deny all liability claims and plan to vigorously defend against these lawsuits. The likelihood of these lawsuits proceeding is considered low, though if legal challenges succeed, additional suits could follow.

If either the city or LADWP were to be found liable, a large settlement against either entity could negatively impact the city and its utility enterprises. Both utilities could legally increase customer rates or issue debt to cover negative judgments. Significant additional borrowing for capital or legal settlements could pressure LADWP's credit. The city's rating also faces pressure from recent revenue declines, federal policy uncertainty, increasing labor costs and liability expenses, and elevated litigation or contagion risks tied to its utilities.

Non-litigation costs have been manageable. LADWP reports estimated physical damage of approximately $93 million for the water system and $23 million for power infrastructure — a small portion of overall operating expenditures. Most costs are expected to be FEMA-reimbursed. Affected areas represent just 1.1% of water system customer accounts and 0.7% of power system customer accounts. Services have been restored to nearly all affected homes and businesses. LADWP credit spreads have narrowed since the wildfires but remain wider than pre-wildfire levels.

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CALIFORNIA MANAGES ITS REVENUE CONCENTRATION RISK

The State of California's current AI boom is reminiscent of the dot-com era in the late 90s. Both then and now, soaring stock prices led to concerns over a bubble. After the dot-com crash, California's revenues fell sharply, unemployment spiked, and the state's budget whipsawed from a $12 billion surplus to over $30 billion in deficits in just a few years. However, California faces the current AI expansion with substantially better fiscal guardrails in place than the state had during the dot-com bust.

The high valuations for AI stock are so concerning because California heavily relies on capital gains revenue from its wealthy residents. In good market years, these gains often make up a significant portion of state income. Personal income taxes account for nearly 70% of the state's general fund revenues, making the state particularly vulnerable to stock market declines.

Additionally, the state's income tax base is comparatively exposed to the tech sector. California's five largest tech firms (Apple, Google, Nvidia, Broadcom and Meta) represent $15 trillion in value, comprising 60% of the Nasdaq 100. Stock-based compensation from tech companies accounts for 25% of withholding growth for 2025-2026 – further linking state revenues to tech and stock market performance.

Understandably, some observers may worry that the state's fiscal stability is once again threatened by the AI boom. However, since the dot-com crash, California has implemented major structural reforms to mitigate such risk. While revenue concentration remains a concern, California's fiscal position today is fundamentally stronger than it was 25 years ago.

Prop 2 enables California to capture revenue upside during booms to prepare for inevitable downturns.

California's Proposition 2 specifically addresses revenue volatility by requiring annual transfers of 1.5% of general fund revenue to the rainy day fund plus additional transfers whenever capital gains exceed 8% of general fund tax revenue. This enables the state to capture the revenue upside during booms to prepare for inevitable downturns.

Proposition 58 prohibits the state from issuing deficit-financing bonds, which it did after the dot-com crash, forcing more immediate fiscal discipline. Proposition 25 lowered budget passage from supermajority to simple majority. It also withholds lawmakers' pay for late budgets, which became a problem following the dot-com crash.

Further, cash flow management tools exist with nearly $90 billion in unused borrowable resources from other state funds. And even more importantly, unlike the prior period, the state now has sizable reserve funds that can be used to address revenue volatility, subject to certain conditions.

STRUCTURAL IMBALANCES PERSIST DESPITE CALIFORNIA'S REVENUE SURGE

The governor's fiscal year (FY) 2026-2027 budget projects a $2.9 billion shortfall, or 1.2% of expenditures, for the state's $248.3 billion general fund spending plan. Despite revenues tracking nearly $45 billion above forecast between FY25 and FY27, state constitutional spending requirements have largely offset this AI-fueled windfall. Specifically, mandated education funding (Proposition 98) and reserve requirements (Proposition 2) pressure expenditures.

Prudently, the budget includes numerous efficiency measures and no new spending proposals. It calls for $11.8 billion in debt reduction over four years and makes a $2.5 billion supplemental pension payment to CalPERS. Additionally, a planned $3 billion deposit into the rainy day fund would increase total reserves to $23 billion, equal to 9.3% of expenditures.

Longer-term structural budgetary imbalances remain. Whether the administration pursues balance through spending discipline and revenue increases or relies on one-time fixes and reserve draws will become clearer with the May budget revision. Deficit financing is prohibited by state law. How the state proceeds will ultimately determine credit resilience to future challenges.

FEDERAL FUNDING FREEZE TARGETS SOCIAL SERVICES

In early January, the U.S. Department of Health and Human Services announced a $10.6 billion funding freeze of social services and childcare programs impacting five states: Minnesota, New York, California, Illinois and Colorado. The freeze was prompted by fraud allegations in Minnesota despite no evidence of widespread fraud in other states.

The affected states immediately filed suit arguing there was no legal basis and that they were politically targeted. A temporary restraining order issued by the U.S. District Court for the Southern District of New York blocked the Trump administration from freezing funding while litigation proceeds.

While politically noisy, Chicago's final budget was only marginally different from the initial proposal.

While litigation and fraud investigations could take months or years to resolve, the fiscal impact is marginal compared to overall state operations. In Minnesota, the threatened freeze accounts for just 0.8% of the state budget. In New York, the funding represents 1.3% of the state budget, and in California, less than 2%.

Additionally, these states maintain strong fiscal positions and rainy day fund balances, providing flexibility to bridge short-term cash flow disruptions. For example, Minnesota ended FY25 with $12 billion in reserves, equal to 34% of revenues. Litigation and investigation outcomes warrant close attention. Although states have considerable financial cushion to manage near-term disruptions, if fraud claims are substantiated, a broader pullback in federal support could necessitate significant budget adjustments.

CHICAGO AVERTS A BUDGET STANDOFF, BUT PROBLEMS PERSIST

For the second consecutive year, Chicago's annual budget process became highly contentious, as the City Council rejected Mayor Brandon Johnson's initial proposal. Starting the year without a budget could have caused a government shutdown and likely resulted in at least one credit rating downgrade.

That outcome was averted when the mayor let a council-led and approved budget stand rather than issuing a veto. The city is currently rated BBB by Standard & Poor's, A- by Fitch and Baa3 by Moody's. S&P and Fitch both maintain negative outlooks while Moody's outlook is stable.

While politically noisy, the final budget was only marginally different from the initial proposal. The mayor's $16.6 billion all-funds budget represented a 4.7% spending increase over the prior year, of which only $6.1 billion is the Corporate Fund. Johnson closed an initial $1.2 billion projected Corporate Fund budget gap with $437.5 million in tax increases, over $230 million in surplus TIF revenues and other one-time measures including a plan to issue debt to fund back-pay and judgments.

The alternate City Council budget kept nearly all the mayor's tax increases, even the largest budget-gap solver: a tax hike on cloud computing services to 15%. The council eliminated a controversial corporate head tax in favor of a plan to sell city receivables to private collection agencies to raise an estimated $90 million — a plan the mayor strongly opposes and may be reluctant to implement.

The final FY26 budget is unlikely to impact the city's near-term credit trajectory, though concerns about mid-year revenue shortfalls and possible layoffs have already surfaced. Like in recent years, Chicago employed a combination of one-time measures and new revenues to address the gap, but real structural changes remain largely absent.

Despite two city-commissioned reports from the Chicago Financial Future Task Force and EY identifying between $530 million and $1.4 billion in potential annual budgetary savings, the FY26 budget does not implement meaningful expenditure

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reductions. The city's ability to address future shortfalls will be constrained by a diminished balance sheet and limited revenue options, with the FY27 budget gap already estimated at $1.17 billion.

CHICAGO'S PENSION CONTRIBUTIONS ARE A GROWING BURDEN

Longer-term, escalating legacy costs threaten Chicago's financial stability. The city's budget grew 40% between 2019 and 2025, primarily driven by pension contributions. Total pension contributions have increased by over 80% in the last 10 years, consuming an ever-larger share of resources. The FY25 budget included $2.8 billion in contributions to the four pension funds, about 16.5% of all-funds spending.

Chicago's total pension contributions have increased by over 80% in the last 10 years.

The city's pension situation worsened considerably in August 2025 when the state enacted legislation (HB 3657) requiring substantially greater contributions for public safety pensions, though this was necessary to remain in compliance with the IRS's Safe Harbor test. The new law adds a projected $60 million in annual costs through 2055 and will decrease the city's funded ratio to an estimated 18%. No state support was provided. The city's combined unfunded pension liability stood at approximately $36 billion at the end of FY24, translating to a dismally low 24.5% funded ratio. In this respect, Chicago is an extreme outlier compared to other large U.S. cities.

From a rating preservation perspective, the most important council change to the FY26 budget was restoring the full $260 million supplemental, advanced pension contribution. The city adopted a new pension funding policy in 2023 that added an annual supplemental contribution, above the required contribution, sized to keep the net pension liability from growing. The new supplemental contribution policy was a clear step toward fiscal discipline, though recent contributions were largely possible because the city received significant federal pandemic relief aid.

The mayor's initial budget proposal cut this supplemental payment in half. This decision combined with the new state law raised sufficient concern for S&P, which promptly placed the city's BBB rating on Negative Outlook in early November. The council's reinstatement of the full advance payment was viewed favorably, though concerns remain about whether the city can maintain adequate pension funding while implementing sufficient structural measures to stabilize its financial trajectory and contain future cost escalation. The city faces a challenging path forward with fewer options for closing future budget gaps.

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