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Illinois Is in Deep Trouble: What Investors Need to Know.

Here are answers to questions investors may be asking

Illinois is locked in a political stalemate, and in danger of becoming the first U.S. state to have its debt downgraded to junk status. S&P Global Inc. threatened to take that action if Gov. Bruce Rauner and Democratic Speaker of the House Michael Madigan can't agree on a package of spending and taxes by the start of the next fiscal year on Saturday. Below is a breakdown of what this unprecedented event would mean for everyone from individual investors to large Wall Street money managers.

Who owns Illinois's debt?

Much of Illinois's $25 billion in outstanding general obligation debt is held by individual investors seeking a stable source of income, according to analysts' estimates. But Wall Street is also exposed via mutual funds, hedge funds and insurers that purchased the state's bonds. Money management giant Vanguard Group has $1.2 billion spread across seven mutual funds. It is the biggest holder among all mutual-fund firms that had a total of $4.5 billion in Illinois bonds, according to the most recent figures from research firm Morningstar.

What would a downgrade do to those investments?

Not much, say analysts. They predict prices would drop only a few cents in the event of a junk downgrade. The state's uninsured general obligation debt traded this week as high as 95 cents on the dollar. Junk bonds don't usually trade near par, but state general obligation debt is considered safer because states have broad power to tax and lack the legal ability to declare bankruptcy.

Will investors still get paid?

A junk rating won't affect the state's ability to pay bondholders. State officials have said those payments are their No. 1 priority.

What does a 'junk' rating mean, anyway?

Ratings firms rank debt according to how safe an investment they believe it is. The 12 safest tiers are considered "investment grade," meaning investors have what S&P terms "adequate" protection against the risk of default. Below that, bonds are considered junk, or "speculative grade," meaning they face "large uncertainties" or "major exposure to adverse conditions," according to S&P. Investors who buy junk may earn greater profits if the bonds perform well but they also face greater danger of losses.

Are mutual funds even allowed to own junk municipal bonds?

Most mutual funds have rules limiting their investment in junk-rated debt, but when bonds drop below investment grade they may not be required to sell them. At Vanguard, mutual funds are allowed to hold a "modest allocation" of junk bonds, a spokesman said. Vanguard's municipal bond team, a spokesman said, is “comfortable with the risk/reward” of investing in Illinois bonds.

How are investors expected to react to a downgrade?

Bonds are still likely to change hands as holders spooked by the state’s deteriorating credit sell and high-yield investors take advantage of the opportunity to buy. Mutual funds have already sold more than $100 million in Illinois general obligation bonds since the end of 2016, according to Morningstar, and buyers have been taking advantage of temporary dips. Howard Cure, director of municipal bond research at Evercore Wealth Management, said some of his clients might buy more Illinois bonds if prices drop further.

How would a downgrade affect Illinois?

The most immediate impact would likely be a rise in borrowing costs, making it more expensive to raise money for new projects. Analysts predict investors could demand an additional half-percent to a percent in interest, meaning the state would pay an additional $5 million to $10 million for every $1 billion it borrows. Illinois already pays a premium. When it last sold tax-exempt debt in November 2016, the state paid yields of 4.4% for 20-year bonds. In contrast, 20-year bonds issued by the state of Wisconsin around the same time yielded 2.8%.

Is Illinois on its way to becoming the next Puerto Rico?

Analysts say no, noting that Illinois’s problems are largely political. Unlike Puerto Rico, which is in the midst of a court-supervised restructuring, Illinois has a strong underlying economy and annual revenues that are about 10 times its yearly debt service payments. Puerto Rico, on the other hand, has endured more than a decade of economic distress. “There’s no risk of Illinois losing market access,” said Matt Fabian, a partner at Municipal Market Analytics.

Will a junk downgrade spill over affect other states and cities?

It could. New Jersey and Connecticut, among the lowest-rated states after Illinois, may face more scrutiny from investors, analysts said. Both are wrestling with budget problems and mounting liabilities. But New Jersey and Connecticut still have a long way to go to match Illinois’s ratings dilemma. They are rated several notches higher by S&P and Moody’s Investors Service.

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