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Illinois Faces Rising Yields as Politics Cloud Return to Market.

- **State is selling $500 million of general-obligation bonds**
- **Yields on its bonds are nearly twice as much as benchmark**

When Illinois returns to the bond market this week, its legacy of protracted fights over the budget will cast a costly shadow.

The lowest-rated state's $500 million sale Wednesday comes as investors demand steadily higher payouts to compensate them for the government's financial strife. While the difference between the yields on Illinois bonds and top-rated securities narrowed sharply after the state boosted taxes and ended its budget impasse in July, the gap has been steadily rising again amid the uncertainty caused by election-year politics.

Yields on Illinois bonds that mature in 2028 have jumped 0.85 percentage point since they were first sold in October, almost twice as much as those on benchmark debt, according to data compiled by Bloomberg.

"The yields will be more than they should be paying given their rating," said Dan Solender, head of municipal investments at Lord Abbett & Co., which holds $20 billion of state and local debt, including some issued by Illinois. "They have a lot of headline risk. The budget is going to be not a simple thing to get through."

Illinois's finances are still recovering from the record budget impasse that ended in July after the Democrat-led legislature overrode Republican Governor Bruce Rauner's veto to enact an income-tax hike to help close the deficit. The gridlock drove unpaid bills to a record $16.7 billion, and that backlog is still nearly $9 billion. The red ink reflects its "strained operating fund liquidity and a history of insufficient revenue," Moody's Investors Service said in a report this month.

Illinois's yields have increased modestly compared with those on other bonds in anticipation of the deal, which follows two large offerings at the end of last year, according to Peter Hayes, head of the municipal bond group for BlackRock Inc., which oversees about $129 billion of state and local debt. Those sales, totaling about $6.75 billion, could curb demand because some investors have diversification rules that limit how much debt they can hold from one issuer, Hayes said.

"There are several elements that are definitely a headwind to Illinois here that investors are aware of," said Hayes, whose firm's municipal holdings include about $484 million of Illinois general-obligation bonds. "That probably will require premium for them to get market."

The state has six weeks to approve a spending plan by a simple majority. After May 31, a higher threshold — three-fifths majority vote in each legislative chamber — is required to pass anything. In February, Rauner, a Republican who is seeking a second term in November, presented his budget for the year that starts July 1. The plan relies on $500 million in savings from shifting pension costs to local school districts and universities, which Democrats have said would be a shock to localities.

Moody’s Investors Service and S&P Global Ratings rank Illinois one level above junk. Investors want to be compensated for the state’s risks, said Dennis Derby, a portfolio manager at Wells Fargo Asset Management, which holds $41 billion of municipal debt, including Illinois bonds. His firm is considering buying the deal, he said.

“We don’t view Illinois as a default risk,” Derby said. “However, there’s obviously very strong headline risk and very strong political risk going into an election year with a budget that feels uncertain at this point in time.”

The budget for the year that ends June 30 still has an estimated deficit of $1.5 billion, according to bond documents. Rauner and lawmakers need to cut costs and or adjust revenue, and there’s no guarantee that might be addressed, according to the documents.

“This is a competitive sale and the market will dictate the levels,” Rachel Bold, a spokeswoman for Rauner, said in an email.

But overall, the financial outlook for the state has improved since last summer, said Neene Jenkins, a vice president and municipal credit analyst at AllianceBernstein, which oversees $41 billion of municipals. That’s reflected in the yield penalty the state pays, which jumped to as much as 3.4 percentage points in June. It’s now just about 2 percentage points.

“We saw some progress last summer,” which the market recognizes, Jenkins said. “There’s still work to be done.”

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By Elizabeth Campbell

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