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Illinois Pension Fix Ends Bleeding Before Bond Sale: Bloomberg Muni Credit.

Illinois's borrowing costs have fallen to the lowest level in six months as investors join Governor Pat Quinn in waging that a law bolstering the worst-funded state pension system has "stopped the bleeding."

The extra yield demanded on 10-year Illinois debt relative to AAA munis reached 1.43 percentage points on Jan. 30, the least since July 18, as the state prepares a \$1 billion general-obligation bond sale this week, according to data compiled by Bloomberg. The fifth most-populous state already spared taxpayers more than \$20 million on an offering in December, less than two weeks after legislators passed a pension bill that saves \$145 billion over 30 years.

Illinois is returning to the \$3.7 trillion municipal market after being spurned by investors over a pension-funding ratio of 40.4 cents on the dollar, the weakest of any U.S. state, and a credit grade that's the lowest. Investors are signaling they agree with Quinn, a 65-year-old Democrat, who in his State of the State address last week said Illinois is making a fiscal comeback.

Illinois "is perceived as being on the right trajectory," said Konstantine "Dino" Mallas, who helps oversee \$20 billion of munis at T. Rowe Price Group Inc. in Baltimore. "I wouldn't say they're out of the woods, but maybe they've stopped digging themselves into a deeper hole."

Python Slain

The state has become one of the most prominent examples of governments across the U.S. that face swelling retiree obligations, which forced officials to allocate tax dollars away from services such as education and infrastructure. Quinn has likened the pension expense to a python strangling the state's finances.

"We can tell the people of Illinois we stopped the bleeding," Quinn said in his address. "We turned the corner."

Adjusted net pension liabilities increased for 38 states in the 2012 fiscal year, Moody's Investors Service said in a report last week. Though Illinois's burden is the highest among states, rising interest rates and gains in stocks reduced the obligation by about 9 percent, according to preliminary 2013 data collected by the New York-based company, which ranks the state A3, four steps above speculative grade.

Updated projections show Illinois's new pension law will save \$145 billion over 30 years, according to offering documents for this week's sale. That's down from an initial \$160 billion estimate. Even so, the system is expected to be fully funded by 2039, earlier than forecast, the documents show.

Appreciative Investors

"Investors indicate a significant interest in Illinois's bond offering," John Sinsheimer, the state's

director of capital markets, said in a statement. "They tell us they understand and appreciate the hard work that went into the passage of our pension reform law."

The most frequently traded Illinois securities are taxable pension bonds due in June 2033, according to data from the Municipal Securities Rulemaking Board. The debt traded last week at an average yield of 5.36 percent, for a spread of about 2.22 percentage points, close to the narrowest in at least a year.

The measure hasn't changed Illinois's negative outlook from Moody's and Fitch Ratings. Standard & Poor's said the state's grade could be raised or cut in the next two years, depending on how the law is implemented. S&P and Fitch both confer an A-ranking to the state, equivalent to the Moody's rating.

Catching Up

Illinois has outperformed a broad municipal-bond rally as investors bet its fiscal health is improving. Its bonds have gained 2.6 percent over the past three months, the most among the 27 states tracked by S&P index data.

"Given that the spread is wider in Illinois than other states, the potential for Illinois to outpace is greater — to catch up to other states," said Robert Amodeo, head of munis in New York for Western Asset Management Co., which oversees \$28 billion in local debt. "Illinois's fiscal condition is better today than it was a few years ago."

Proceeds from this week's deal will fund school construction and transportation projects under the Illinois Jobs Now capital program. Quinn said in his address last week that the state has invested more than \$31 billion into roads, bridges and highways through the initiative.

Legal Challenges

The state may have to boost yields to find enough demand for such a large offering, Amodeo said. While the spread to AAA munis is already wider than any other state's, investors will demand compensation for the risk that the pension law will be overturned in court and that lawmakers won't extend tax increases set to be phased out in fiscal 2015.

"They will find sufficient demand to match that size; it may just cheapen up a bit," Amodeo said.

A union coalition filed a lawsuit last week claiming the December pension bill is unconstitutional and amounts to "theft." It joins retired teachers and state employees in challenging the legislation. Illinois acknowledges in offering documents that more groups may follow.

The plan lawmakers passed last month addresses the \$100 billion public pension shortfall through smaller cost-of-living adjustments and later retirements.

"Teachers, nurses, emergency responders, and other workers and retirees will not stand by while politicians try to take away their life savings illegally," state AFL-CIO President Michael Carrigan said in a statement.

Tax Hurdle

The Democratic legislature raised the individual income tax rate to 5 percent from 3 percent in 2011. The levy is scheduled to drop to 3.75 percent after Dec. 31. Including the promised reduction in the corporate tax rate, Illinois's collections would fall by as much as \$5 billion annually, offering

documents show.

“One of their largest hurdles is on the revenue side,” Mallas of T. Rowe Price said. Should lawmakers fail to extend the higher tax rates, it would be “very disappointing” for investors, he said.

Illinois may benefit from a lack of supply. States and cities issued \$12.6 billion through Jan. 24, down 33 percent from the same period last year, data compiled by Bloomberg show.

As withdrawals from muni mutual funds have abated, yields have fallen to close to the lowest levels since June. That was when the state last issued tax-exempt general obligations, amid the worst monthly rout for state and local bonds since the financial crisis in 2008.

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