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States’ Finances Are Now on Solid Ground: Barron's.

U.S. states represent one of the most secure areas of the global bond market, typically benefiting from low debt levels relative to the size of their economies, and the ability to cut spending and raise taxes during tough times.

Even when hefty pension obligations and unfunded employee health-care liabilities are taken into account, state credit quality generally is strong. The $518 billion of state general-obligation bonds and other state-supported debt are probably the best slice of the $3.7 trillion municipal-bond market. General-obligation bonds are backed by the issuer’s full faith and credit.

“The most important factor about state credit quality is that states are sovereign entities that have the ability to raise revenues or cut spending as needed,” says Tom Kozlik, a municipal analyst at Janney Capital Markets in Philadelphia. There hasn’t been a state-government default since the Depression.

Reflecting all of this, both Moody’s Investors Service and rival Standard & Poor’s give a triple-A rating to 15 states. Only Illinois and New Jersey have a Moody’s rating below double-A. In contrast, just three U.S. companies, ExxonMobil (ticker: XOM), Microsoft (MSFT), and Johnson & Johnson (JNJ) have triple-A ratings from both rating agencies. Even the U.S. government lost its triple-A rating from S&P in a controversial 2011 action, and mighty Apple (AAPL), with its $120 billion of net cash and $40 billion of annual income, merits only a double-A1 rating from Moody’s and a AA+ from S&P, a notch below triple-A.

“While most state credits are stable and have improved in the past three years, a few have struggled. Illinois, New Jersey, and Connecticut aren’t fully funding their pension obligations, have thin financial reserves, are structurally imbalanced, and are using one-time revenue sources to balance budgets,” says Jim Evans, a portfolio manager at Eaton Vance, an investment manager with a specialty in municipal bonds.

Atop the list are North Dakota, Wyoming, and Utah, which boast modest liabilities, ample cash, and strong economies.

New Jersey’s fiscal woes, which stem largely from a lackluster economy and persistent underfunding of its pension program, could have political implications if Republican Gov. Chris Christie enters the 2016 presidential race.

Fiscal trends generally have been positive. Nearly every state has enacted some pension reform since 2009 that either reduces benefits or increases employee contributions, and debt issuance has been light in the past two years. And laggards New York and California have shown improving finances and garnered rating upgrades.

There are some negatives. State tax revenue fell 1.2% in the second quarter, marking the first quarterly drop since 2009, Rockefeller Institute data show. And many states continue to underfund their pension plans. Most have set aside no reserves to finance postretirement health-care benefits for employees. These expenses are paid annually out of the state budget. In that regard, some investors are worried about the Detroit precedent. Bondholders fared worse than pensioners in the city's bankruptcy settlement, and that treatment could be repeated if a state gets into financial distress. The situation is the same in troubled Puerto Rico. Island politicians are putting local interests and constituents ahead of bondholders.

STATE GENERAL-OBLIGATION, or GO, debt has rallied this year in a strong muni-bond market. Total returns (income plus capital appreciation) so far in 2014 on long-term munis are about 13%. When Barron's looked at the states a year ago ("Munis on the Mend," Cover Story, Oct. 14), most state GO debt with maturities of 30 years carried yields in the 4.2% to 4.7% range, with the only outlier being Illinois, whose debt yielded about 5.75%. The 30-year Treasury stood at 3.75%. We argued then that state GOs were a "good play for risk-averse investors."

It's harder now to get excited about state GOs—and other munis—with many long-term state GOs offering yields in the 3.2% to 3.6% range. Illinois remains an exception, with a 4%-plus yield. California's 30-year debt is about 3.45%, and Connecticut's, 3.6%, while top-rated states like Virginia and Minnesota are closer to 3.2%.

New Jersey long-term general-obligation debt yields about 3.75%, but it trades lightly because only about $2 billion is outstanding. The more actively traded bonds are the state's $32 billion of debt supported by legislative appropriation, such as the New Jersey Transportation Trust Fund Authority. These carry a slightly lower rating than Jersey GOs and can yield 4.25% or more.

Yields on state general-obligation paper compare favorably with the 30-year Treasury's 3%, especially on an after-tax basis. Yet, absolute yields aren't high and provide little cushion above inflation, and investors could suffer sizable losses if rates do rise and they sell their bonds before maturity.

The table on this page shows the yield premium, measured in hundreds of a percentage point, of 10-year state general-obligation debt above a triple-A benchmark, now 2.15%. Reflecting strong state credit quality, most 10-year GOs trade close to the triple-A benchmark. It should be said that ratings and spreads for some states are more indicative than real, because they have little or no GO or state-supported debt outstanding. These include Nebraska, Wyoming, and North and South Dakota.

Barron's has looked at state financial health for the past three years using data compiled by Eaton Vance. This year's tally differs from last year's because it offers a more comprehensive picture, based on about 10 measures that factor in assets, liabilities, and other gauges of economic health. The 2013 rankings were based only on the states' debt and pension liabilities relative to their economic output. That approach had merit because it highlighted the growing pension burden in many states—an issue to which many investors have paid little attention.

The broader approach taken by Eaton Vance this year offers a holistic look at state finances beyond debt and pension liabilities. The firm has added other post-employment-benefit, or OPEB, liabilities, which is dominated by unfunded health-care obligations to get a more complete snapshot of state liabilities. The total of those three figures, relative to each state's economic output, is shown in the table on page 24.

PENSION AND HEALTH-CARE liabilities matter because they dwarf outstanding state debt and aren't easily extinguished, thanks to legal protections. Eaton Vance puts unfunded state pension and health-care costs nationwide at $1.6 trillion, or three times the amount of state debt. The firm estimates health-care liabilities because states don't provide much information on which portion is their responsibility and which portion is the obligation of local governments. Eaton Vance assigns the full health-care burden to the state, meaning the liability could be overstated. Whether overstated or not, unfunded postretirement employee health-care liabilities are a major problem for state and local governments. In the Detroit bankruptcy, one of the city's largest obligations was unfunded health-care costs.

Other factors that figure in Eaton Vance's proprietary analysis include the funding status of state pension plans and whether states are making the actuarially mandated contribution to their pension fund each year.

Some states, such as New York, have made ample annual contributions, while others, including New Jersey, Pennsylvania, and Illinois, have not. To balance their budgets, these states have skimped on their pension contributions in recent years, but that simply defers the ultimate payment and has contributed to their weakening credit quality.

To evaluate debt-payment ability, Eaton Vance incorporates the asset side of states' balance sheets by looking at cash and investment levels. It also focuses on several economic indicators, including the jobless rate, the state's gross-domestic-product growth, wealth, tax burden, and population gains. The firm assigns different weights to each of the measures to come up with an overall state ranking.

"To get a true measure of state rating, you have to look at liquidity reserves and the health of the state economy and the state's ability to raise taxes," says Bill Delahunty, director of municipal research at Eaton Vance.

THE TOP THREE STATES aren't necessarily tops in the two categories shown in the table. In fact, North Dakota is 14th nationally in the debt, pension, and health-care measure.

Delahunty says that North Dakota is a prime example of why it's important to look beyond the debt, pension, and health-care total. The state has the lowest unemployment rate in the country, 2.7%, thanks to an energy boom, and it has had the highest economic-growth rate of any state over the past three years. North Dakota also has a large cash pile—enough to fully fund its pension plan and still have ample liquidity left over.

Wyoming has a healthy economy, minimal debt, the lowest tax burden of any state, and a large cash hoard, sufficient to support its budget for four years. And, Delahunty says, the state could fully fund its pension plan with a modest contribution from its rainy-day fund.

Wyoming Gov. Matt Mead emphasizes the importance of pension funding. "If I were a company moving to a state, I would want to know how those pension plans are doing because I wouldn't want to make a 20-year commitment to a state that's going to raise taxes because they're underwater on their pension plans," he tells Barron's.

With no state income tax, Wyoming is an anti-California—and it plans to stay that way. "I think it's very tempting sometimes to raise taxes if you want to raise revenue. But when I've seen the economic development we've had in the past 3½ years, I'm telling you, it's a huge deal to have the lowest taxes in the country," Mead adds.

Utah has little debt and makes ample annual contributions to its pension plan. The state also has one of the lowest jobless rates in the country and the second-highest median household income, adjusted for the cost of living, behind Virginia.

Despite Utah's sterling credit quality, Gov. Gary Herbert argues that there's room for improvement, such as cutting the state's modest debt of $2.6 billion. "It's just a little bit high. Either way, we're one of only nine states with a triple-A bond rating [from all three main rating agencies]. So we're in pretty good shape. I just want to make sure we don't jeopardize that."

Alaska had the country's largest pool of cash and investments, totaling $69.6 billion at the end of its fiscal 2013, stemming largely from energy taxes. That money is sufficient to fund the northernmost state's annual budget for five years, and Alaska is contributing money from that fund to shore up its pension plan.

The worst-ranked states, Illinois and New Jersey, do poorly when gauged by most key metrics. Illinois has the worst-funded pension plan among the 50 states—just 30%—based on Moody's analysis. Its total unfunded pension liability of $168 billion also is the second worst in the country behind California, says Moody's. And Illinois has one of the highest rates of unemployment, at 8.4%.

In addition, Illinois' finances could get pressured because temporary income-tax surcharges start to expire on Jan. 1, 2015. "Illinois is underfunding its pension plan, and it's getting more and more difficult to climb out of that hole," Delahunty observes.

PERSISTENT PENSION underfunding in the administration of Gov. Chris Christie and his predecessors is plaguing New Jersey, which has one of the lowest funding ratios of any state and the worst average annual pension contribution over the past three years, relative to actuarially required levels. The worsened outlook has come despite the pension reforms that Christie pushed through in 2011.

"New Jersey continues to struggle with structural imbalance, and the governor's decision to reduce pension contributions in fiscal 2014 and 2015 highlights the fact that the state lacks the revenues to comply with its own agreed-on contribution to the pension system," S&P wrote in explaining its downgrade of New Jersey general-obligation paper to A from A+ in September. The rating agency added that the state is closing its budget gap by employing "one-time measures, such as legal settlements, debt restructurings, and pension-payment deferrals."

Big, scheduled, annual increases in the New Jersey pension contributions, to $4.8 billion in fiscal 2018 from $2.25 billion in the current year, threaten to crowd out other state expenditures. And with the nation's second-highest combined state and local tax burden behind New York, the Garden State has little room to hike taxes.

Pennsylvania, ranked No. 47, has been hurt by a weak economy and a growing pension liability. These factored into a Moody's downgrade in July, when the state's credit rating fell to Aa3 from Aa2. Tax-revenue growth has been sluggish since the recession, despite the state's energy boom tied to hydraulic fracturing in the vast Marcellus shale deposit.

Pennsylvania has a low, flat income tax rate of 3.1%—below the top rates of almost 9% in neighboring New Jersey and New York—but a tax increase looks unlikely.

Janney's Kozlik regularly is asked by investors about Pennsylvania's relatively low income tax. "Try running for governor in Pennsylvania and telling residents that you're going to raise their taxes because people in New York and New Jersey are paying more," he says. The combined state and local tax bite in Pennsylvania, however, is in the top quartile in the country, according to data from taxfoundation.org.

A sluggish economy and weak pension funding are weighing on Connecticut. The state also has lost some of its appeal as a tax haven for New Yorkers because its top income-tax rate has risen to almost 7%.

NEW YORK is a bright spot in the fiscally challenged Northeast, thanks to the strength of the New York City economy, spending restraint, and conservative financial management, including strong pension funding. The state's unfunded pension liability is just over half of smaller Connecticut's. The Empire State continues to rely too heavily, however, on the superwealthy, including hedge fund managers and private-equity chieftains, who pay a large chunk of the state's income taxes. And the volatile income tax kicks in 60% of state revenue, about twice the national average.

California so far is defying supply siders who argued that a 2012 tax increase that lifted the top income-tax rate to 13%—for those earning more than $1 million—would drive the affluent out of the state. It has the highest top tax rate in the country and doesn't offer a preferential rate on capital gains, which has meant that those cashing in options and restricted stock at highflying technology companies like Facebook (FB) and Twitter (TWTR) face a stiff combined federal and state capital-gains tax bite. California got a Moody's upgrade to AA3 from A1 in June, and the rating agency recently cited the state's "rapidly improving financial position." California has gone from having huge budget gaps after the 2008 recession to boasting a surplus in the latest fiscal year.

Like New York, California is heavily dependent on its income tax, which similarly kicks in 60% of revenue and is paid disproportionately by its ultra-rich. Structural impediments also are a problem in tough times because it takes a vote of two-thirds of the legislature to raise taxes.

PUERTO RICO REMAINS in a class by itself, with far higher yields than those of any state and a poor economic and financial situation. The commonwealth's benchmark 8% bond due in 2035 that was sold in a $3.5 billion deal in March now trades at 87 cents on the dollar for a 9.4% yield. That's equivalent to a 15% on a fully taxable bond for someone in the top federal tax bracket. Few dollar-denominated bonds from any country yield so much, even before the tax benefit.

The issue for investors is whether that yield compensates for the risk, especially after Puerto Rico enacted legislation that is expected to lead to the restructuring of certain public utilities, including the island's electric and highway authorities. Reflecting this, the long-term debt of the public authorities trades around 50 cents on the dollar. The commonwealth's strategy is to wall off its GO debt and tax-supported Cofina bonds—the name comes from the Spanish words for Puerto Rico Sales Tax Financing Corp.—from the troubled authorities.

There's little evidence that the depressed Puerto Rican economy is turning around, and the island remains burdened by a badly underfunded pension plan. Eaton Vance analysts cite other negatives, including high electricity costs, population loss, and a looming budget gap in the current fiscal year, despite major initiatives to finally achieve balance. The commonwealth is considering a $2.5 billion bond issue in the coming months that would offer a fresh test of investor demand.

Aside from Puerto Rico and a handful of states, credit quality is strong at the state level, making municipal bonds an attractive option for income investors. Too bad muni yields are so low.

BARRON'S

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