
For Some Bond Investors, Chicago Isn't Their Kind of Town.

A big pension shortfall is buffeting the Windy City. Fearing that the multibillion-dollar gap might undermine Chicago's finances, some bond investors and credit-ratings firms are becoming wary.

Four pension funds in the nation's third-largest city are facing a combined funding gap of about $20 billion after years of underfunding and market losses during the recession. In comparison, Chicago has a $3.5 billion annual budget for general operating expenses.

Moody's Investors Service cut the city's credit rating in February to Baa2, two notches above junk status, and maintained a negative outlook. The firm warned that the city's "highly elevated" unfunded pension liabilities could increase, "placing significant strain on the city's financial operations." Other ratings firms give the city higher grades.

The concerns come as an April 7 mayoral runoff election approaches, pitting Mayor Rahm Emanuel against Jesus "Chuy" Garcia, a county commissioner. The city's finances have featured prominently in the election campaign.

To make matters worse, there is a real possibility that Chicago may have to pay higher interest rates to issue new bonds.

Three bond insurers, Assured Guaranty Ltd., National Public Finance Guarantee Corp. and Build America Mutual, already have backed billions of dollars combined of Chicago bonds and are at or near their limits for how much Chicago debt tied to property taxes they are willing to insure, said people familiar with the matter. An insurer agrees to make payments if the municipality defaults, so no insurance means Chicago would have to offer higher interest rates on any new bonds to compensate investors for the added risk.

The situation is an example of how municipalities across the country still are struggling to fill gaps in their pensions, which sustained losses on investments during the financial crisis. The troubles are prompting investors to avoid debt from municipalities with large pension-funding gaps, like New Jersey, fearing officials would have to choose between promises made to bondholders and employees.

In a statement, the mayor's office said Mr. Emanuel has "worked to right the city's financial ship." The statement also said the mayor has been clear that "Chicago's pension obligations were the biggest threat to the city's financial security."

Burton Mulford, a portfolio manager at Eagle Asset Management Inc. in St. Petersburg, Fla., said his firm has been staying away from Chicago bonds and is waiting until the pensions are in better shape.

"There's going to be a lot more pain before there's improvement," said Mr. Mulford, whose firm oversees $2.2 billion in municipal bonds.

Some Chicago bonds have largely missed out on a bond-market rally due to the concerns. The price of a 30-year Chicago bond sold in March 2014 has risen 2.7% over the past year, compared with a 22% jump in the price of a similar-maturity U.S. Treasury bond. The yield on the Chicago bond decreased from 6.3% at the time of sale to 6.1% when it last traded in mid-March, while the 30-year Treasury bond decreased from 3.6% to 2.5% over the same period. Yields fall when prices rise.

The pension gap in Chicago has some analysts warning the city could in a decade or more face the same fate as Detroit, which also had pension shortfalls before it filed for bankruptcy protection in 2013. Although Chicago's economy is more robust, some investors said Chicago needs to address its pension situation.

"Chicago is Detroit 10 to 15 years from now, if they do not deal seriously with this pension problem," said Tom Metzold, senior municipal portfolio adviser at Eaton Vance Management, with $28.3 billion of assets under management. Mr. Metzold said his firm has "virtually no holdings" in Chicago debt.

Mr. Emanuel has supported overhauling the city's pensions, which are governed by state law. Last year, state lawmakers agreed to reduce benefits for city workers and retirees in two of the plans. The overhaul, however, has been challenged in court.

Another problem for the city: The ratings cut by Moody's triggered potential fees of about $38 million on interest-rate swaps tied to Chicago bonds. The swaps were designed to protect the city from increases in interest rates, but rates fell instead. The city has said it is in discussions with Wells Fargo & Co., which is a party to the swaps, regarding the fees. Wells Fargo declined to comment.

Financial problems aren't limited to the city itself. The Chicago Board of Education, which is separate from the city but whose board members are appointed by the mayor, is facing $228 million in potential swap fees after a series of credit downgrades. The school district said it is working to renegotiate the swap terms.

Not everyone sees Chicago's situation as dire. Fitch Ratings gives Chicago a single-A-minus rating, two notches above Moody's, and Standard & Poor's Ratings Services rates the city at single-A-plus, four notches above Moody's. And some traders sense an opportunity in Chicago bonds.

Dominick Mondi, president of global markets at Mesirow Financial, a Chicago-based financial firm, said yields on Chicago bonds are reasonable compared with other bonds, like debt from hospitals, that carry ratings similar to Chicago's Baa2 mark from Moody's. "There is a vibrant, alive downtown," said Mr. Mondi, highlighting one of the city's economic strengths.

Some investors said there will be appetite for Chicago debt, even without insurance guarantees, if yields are high enough.

"Chicago's economy is doing fairly well," said John Miller, co-head of fixed income at Chicago-based Nuveen Asset Management LLC, which oversees about $100 billion in municipal debt, including some Chicago bonds. "Education and health-care institutions are really strong."

THE WALL STREET JOURNAL

By MIKE CHERNEY And AARON KURILOFF

April 1, 2015 6:18 p.m. ET

—Mark Peters contributed to this article.

Write to Mike Cherney at mike.cherney@wsj.com and Aaron Kuriloff at aaron.kuriloff@wsj.com