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Chicago's Junk Rating From Moody's Puzzles Investors.

No U.S. city has provoked a bigger disagreement between the two largest bond-rating companies than Chicago. Investors aren't sure whom to believe.

Moody's Investors Service has cut the third-largest city's rating seven levels since July 2013, most recently knocking it this week to Ba1, one step below investment grade. Standard & Poor's has rated it A+, the fifth-highest rank, for more than four years.

The six-level split is more than for any other city and unheard of for an issuer with $8.1 billion of general-obligation debt like Chicago, said Matt Fabian, a partner at Municipal Market Analytics. As the city plans $383 million of refinancing deals next week, trading in the $3.6 trillion market signals bond buyers are moving closer to Moody's view, while stopping short of assessing it like junk.

"The market is having difficulties on price discovery," said John Donaldson, who helps manage about $700 million of munis, including Chicago debt, as director of fixed income at Haverford Trust Co. in Radnor, Pennsylvania. "What level should something with that big a gap trade at?"

Emanuel's Response

Moody's lowered Chicago's grade after the Illinois Supreme Court rejected a state pension-overhaul plan May 8. The New York-based company said the ruling reduced the city's options for fixing its own system, which is underfunded by $20 billion. Mayor Rahm Emanuel, who last month announced a plan to fix the city's financial mess, called the rating cut an "irresponsible decision."

Federally tax-exempt Chicago bonds maturing in January 2033 were the city's most frequently traded securities on Thursday, according to data compiled by Bloomberg. They changed hands at an average yield of 5.89 percent, the highest since they were issued in March 2014.

By comparison, the yield on an index of BBB general obligations with an average maturity of 16.9 years is 5.2 percent, Bank of America Merrill Lynch data show. It's 7.9 percent for Bank of America's high-yield muni index, which has an average maturity of about 19 years.

Chicago issuers have started to shun Moody's in bond offerings. Both the Chicago Park District and Chicago Transit Authority didn't use a Moody's rating in June 2014 deals, data compiled by Bloomberg show. S&P rates the two issuers AA+ and AA, respectively, the second- and third-best grades.

The Chicago Board of Education excluded Moody's when it sold $300 million of debt last month.

Schools Downgraded

Moody's dropped the school system's grade again Wednesday, cutting $6.2 billion of general obligations to Ba3, three levels below investment grade. The park district fell to Ba1, the same as the city. The company said the ratings reflect the strain of Chicago's swelling retirement bills.

That emphasis on unfunded pension obligations differentiates Moody's approach, said Paul Mansour, head of municipal research at Conning, which oversees $11 billion in munis for insurance companies.

"Moody's rating methodology happens to disadvantage Chicago tremendously," said Fabian at Concord, Massachusetts-based MMA, a research firm. "Chicago is a big, vibrant city that has a lot of things going for it, but it also has this gaping pension problem."

David Jacobson, a Moody's spokesman, referred to Tuesday's report to explain the company's rating. Alex Ortolani at S&P referred to a statement from analyst Helen Samuelson. She said the company would monitor how the Supreme Court ruling affects the city's plan to address its unfunded pensions.

More Downgrades

Fitch Ratings and Kroll Bond Rating Agency both rate the city A-, two steps below S&P. The three companies will probably downgrade the city multiple levels because of the liquidity risks, Nuveen Asset Management said in an e-mailed report Wednesday.

Using Moody's assessment, Chicago and some of its related entities now comprise the largest segment of the high-yield municipal market outside of Puerto Rico and tobacco bonds. Moody's cut at least $15.7 billion of Windy City debt to speculative grade this week.

The only issuers with such divergent ratings are also deemed junk by Moody's. They include Clarendon Hospital District in South Carolina, school warrant obligations from Jefferson County, Alabama, and Yeshiva University in New York.

"Puerto Rico was a much worse credit at investment grade than Chicago is at non-investment grade," Fabian said. "Maybe it's not appropriate that Chicago be rated by Moody's anymore."

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