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Big Demand Slices Yields for $674 mln of Chicago Bonds.

May 27 (Reuters) – Strong investor demand pushed yields lower for $674 million of Chicago bonds priced on Wednesday, but the city continued to pay a penalty for its shaky finances.

Carole Brown, Chicago's CFO, said the four bond issues attracted $6 billion in orders.

"This further shows that investors remain confident in the city's credit and a secure economic future for Chicago," she said in a statement.

Chicago initially offered bonds due in 2042 with a hefty 6 percent yield and 5.75 percent coupon. A repricing cut the yield by 16 basis points to 5.84 percent with a 5.50 percent coupon. The lower yield compressed the spread over Municipal Market Data's benchmark triple-A scale for the U.S. municipal bond market to 264 basis points from 280 basis points. The city's bonds had been trading about 300 basis points over the scale.

But the spread was still nearly 300 basis points over the scale for yields on bonds due in 2021-2013, according to MMD. While there was big demand for long bonds, underwriters had to take some bonds with shorter maturities into their inventories, a market source said.

On May 12, Moody's Investors Service downgraded Chicago's credit rating to junk, due to an Illinois Supreme Court ruling that narrowed the city's options for dealing with its $20 billion unfunded pension liability.

Tom Metzold, a portfolio manager at Eaton Vance Management, said he did not participate in the deals.

"We didn't think (the bonds) were priced appropriately given (the city's) risk profile," he said.

The city, the third-largest in the United States by population, is struggling with a $300 million structural budget deficit and a looming $550 million contribution increase to its public safety workers' retirement funds.

Yields in several maturities in the four issues repriced through lead manager Bank of America Merrill Lynch fell by 1 to 15 basis points.

The general obligation bond issues are part of Chicago's plan to convert about $805 million of variable-rate debt to fixed rate and end related interest-rate swaps and bank letters of credit.

The Moody's downgrade triggered $2.2 billion in accelerated debt and fee payments by Chicago. However, the city entered into forbearance agreements with banks that provided letters of credit backing the variable-rate debt or swaps used to hedge interest-rate risk on it, according to city bond offering documents. Those give Chicago until June 8 to complete converting the bonds to a fixed-rate mode.

By Karen Pierog

(Reporting by Karen Pierog; Editing by Jeffrey Benkoe, Dan Grebler, Christian Plumb and David Gregorio)