# Junk-Bond Stigma is Costing Chicago.

(Bloomberg) — Chicago is paying a price for the $20 billion pension-fund shortfall that pushed it into junk-bond territory.

The nation's third-most populous city had to pay yields approaching 8 percent as part of a $743 million taxable-bond offering Wednesday. That puts it in the company of issuers such as telephone company CenturyLink Inc., whose $650 million of similar-maturity securities yield 8.53 percent.

Chicago has been stung by rising borrowing costs as Mayor Rahm Emanuel refinanced floating-rate debt over the past two months, seeking to avoid as much as $2.2 billion of penalties triggered when Moody's Investors Service cut it below investment grade. The May downgrade left the city of 2.7 million with a lower rating than any major U.S. city except for Detroit, a result of years of failing to put enough into its retirement system to cover promised benefits.

"They've taken a notch in the right direction by reducing the liquidity threat related to variable-rate debt," said Richard Ciccarone, chief executive of Chicago-based Merritt Research Services LLC, which analyzes municipal finance. "But the city will pay a price, and deservedly so."

ADDITIONAL LIABILITIES

Chicago's pension obligations are rising, increasing pressure on officials to boost property taxes. The city owes an additional $550 million to police and fire funds next year.

Lawmakers approved a plan to reduce that payment, but Governor Bruce Rauner has yet to sign it. Uncertainty around the city's pension liabilities worsened after the state Supreme Court ruled that Illinois can't lower retiree benefits, casting doubt on Chicago's overhaul of its pension system to stem costs.

The taxable issue and a $344 million tax-exempt offering set for Thursday are the last in Emanuel's plan to convert variable-rate bonds to fixed-rate securities. The floating-rate debt threatened to add to Chicago's financial pressures because its tumbling credit rating allowed banks to force Chicago to pay it off early, which it couldn't afford to do.

'We expect continued positive investor feedback on the City's reform efforts," Elizabeth Langsdorf, a city spokeswoman, said in an e-mailed statement.

COURT DECISION

The city's escalating borrowing costs are a consequence of a financial outlook that has yet to improve, said Paul Mansour, head of municipal research at Conning & Co., which oversees about $11 billion in municipal debt, including Chicago holdings.

He said he's not going to buy any of the debt.

The Chicago bonds sold Thursday are exempt from the federal income tax, so the yields will be lower than those set Wednesday. The city’s tax-exempt bonds maturing in 2035 last traded for a yield of 5.6 percent, about 2.5 percentage points more than top-rated debt, according to data compiled by Bloomberg.

The latest sale, authorized by the city council on June 17, will also allow Chicago to push some bills into the future, said Matt Fabian, a partner at Concord, Massachusetts-based Municipal Market Analytics.

Chicago’s effort to close the gap in its pension funds could be dealt a setback in court as soon as next week, when a judge is to decide whether Emanuel’s overhaul of the pension system is legal. The restructuring, affects about 60,000 municipal employees. Some unions sued to block its implementation.

INVESTOR RISK

If the judge overturns the law, Chicago’s credit rating may be cut further, Fabian said. Chicago could have junk ratings from all four rating companies in the next two years, he said.

“With the risk of them potentially losing more investment grade ratings, buyers can’t be aggressive,” Fabian said.

“There aren’t many speculators who are willing to make a bet on Chicago tightening yet. This is a kind of deal that would price cheaply.”

John Donaldson isn’t among such speculators. Donaldson, who helps manage about $700 million of munis, including Chicago debt, as director of fixed income at Haverford Trust Co. in Radnor, Pennsylvania, said he’s steering clear of the city.

“We’ve shied away from it,” Donaldson said. “It’s all the liabilities, including the pension, current budget. Do I need that headache right now? No, I do not.”

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