Chicago Worth the Risk to Pimco, Wells Capital as Deficit Swells.

As Chicago wrestles with rising pension costs, cash-strapped schools and a swelling budget deficit, investors from Pacific Investment Management Co. to Wells Capital Management say they aren't counting the Windy City out.

Wells Capital is increasing its exposure to the junk-rated metropolis, while Pimco said this week it sees long-term value in the city's debt. A longer-term perspective may come in handy, with a judge to rule Friday on the legality of an overhaul of two of four city employee-pension programs.

"Our big point is not that the city and its finances are necessarily on a very short-term upward trajectory, but that investors are being paid to be there," said Gabe Diederich, a Menomonee Falls, Wisconsin-based portfolio manager at Wells Capital, which manages about $39 billion of munis, including $529 million from Chicago. "The city has options longer-term to correct their finances."

The nation's third-most populous city had to pay yields approaching 8 percent as part of a $743 million taxable-bond offering last week, putting it in the league of junk issuers such as telephone company CenturyLink Inc. A $346 million tax-exempt portion of the sale yielded as much as 5.7 percent.

Pension Turmoil

Already the worst-rated major city except Detroit, Chicago risks being downgraded again if the pension changes are overturned. Yields on Chicago debt are close to the highs reached after Moody's Investors Service cut the city's credit rating to below investment grade in May.

"Despite the fact that we all know that they have their problems, and Chicago politics and Illinois politics are really, really difficult, it's hard to ignore that kind of embedded yields," said Jim Colby, chief municipal strategist at Van Eck Global, which bought some of Chicago's tax-exempt deal last week. "I know the risks."

Chicago and the state of Illinois are among localities that have shortchanged retirement funds for years. Pensions in the U.S. have $1.4 trillion less than needed to cover promised benefits nationally, according to Federal Reserve figures.

The pension system in Chicago is $20 billion short, and the state of Illinois's retirement fund has a $111 billion shortfall. Chicago's retirement system is only 36 percent funded as of December 2014, compared to 61 percent in 2005.

Union Lawsuits

A partial solution was found last year when state lawmakers approved a plan, touted by Mayor Rahm Emanuel's administration, that restructured the pensions of the laborers and municipal workers. That affects about 60,000 workers. The fix forces employees to pay more with lower benefits while also boosting the city’s contribution. Some unions sued to block the law that went into effect Jan. 1.

Friday’s ruling will decide whether that law is constitutional. The decision is expected to be appealed to the state Supreme Court, which in May unanimously ruled that Illinois couldn’t cut retiree benefits. Four days later, Moody’s cut Chicago’s credit to Ba1, one step below investment grade, saying the decision increased the likelihood that the city’s reform won’t hold up.

“Seeing how the state supreme court ruled earlier in the spring, I don’t expect the decision to go favorably for Chicago,” said Joseph Gankiewicz, an analyst at Blackrock Inc. in Princeton, New Jersey, which oversees $116 billion in municipal debt and owns Chicago bonds. “Now with that said, it might give cover to some of the rating agencies to downgrade the city.”

Chicago’s Viewpoint

If the law is overturned, Chicago’s pensions will be broke in about 10 years, the city’s lawyers have argued.

“An adverse ruling from the circuit court and from the Illinois Supreme Court is just going to make it more difficult for the city of Chicago to extricate itself from its financial difficulties,” said Sarah Wetmore, vice president of the Civic Federation, a watchdog group that has been tracking the city’s finances since 1929.

The city said it could be downgraded again if the court finds the law unconstitutional, according to bond documents for last week’s bond sale.

City officials, including Emanuel, have said the city’s plan “fully complies” with the state constitution since it protects benefits and ensures that the funds will stay solvent.

Payment Jumps

Chicago’s changes didn’t affect the pensions of police officers and firefighters. The city’s payment into their funds will jump by $550 million next year. While the Democrat-led legislature passed a plan to lower that bill, Republican Governor Bruce Rauner has yet to sign it.

Even with its retirement debt, Chicago has the capacity to raise revenue to meet those liabilities, said Matthew Sinni, New York-based vice president and municipal credit research analyst at Pimco, which manages about $40 billion of state and local debt.

“Despite its pension overhang, Chicago remains a dynamic city with sufficient revenue capacity to meet its steep fiscal challenges in the coming years,” Sinni said in the blog post on July 20. Pimco declined to comment beyond the note.

Pressure from pensions is expected to ramp up next year as Chicago owes about $1.1 billion to its retirement funds in 2016 if current law stands. The city is projecting a budget shortfall of $430 million next year, up from $297 million this year, according to bond documents.

It’s hard to believe that Chicago won’t find a solution, whether it’s cutting spending or raising taxes or fees to “rehabilitate their credit profile,” said Van Eck’s Colby, who has about $3 billion in tax-exempt assets across six exchange-traded funds, two of which are high-yield.

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