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Investors See Golden Opportunity in Chicago's Budget Woes.

Mayor Rahm Emanuel has warned Chicago homeowners that property tax bills could "explode" without budget relief from Springfield. The Chicago Public Schools are facing massive budget cuts that would force hundreds of layoffs. Residents across the city are paying higher fees for water, vehicle stickers, cable TV and more.

But there is one group that looks at Chicago's financial mess and sees a golden opportunity: the affluent individuals, investment funds and other global companies that buy the city's debt.

Some city bonds sold this month pay returns on par with what investors earn on lucrative but risky junk bonds sold by distressed oil and gas companies. Unlike corporate bonds, the city's debt is guaranteed by an unlimited flow of tax dollars from Chicago residents.

The forces making Chicago bonds a hot commodity are as old as the free market. As the risk grows that the city will default on its debt, investors demand higher returns. Some risk-averse buyers avoid Chicago debt altogether.

But to investors who can tolerate the risk of default – or think it is overstated – Chicago bonds can look tantalizingly lucrative.

Those investors are betting that Chicago residents will ultimately shoulder the cost of the city's massive borrowing, whether by enduring service cuts, by indebting future generations or by paying significantly higher property taxes.

The investment banking arm of the London-based bank Barclays declared in a research report last month that Chicago city bonds "present attractive strategic opportunities," reasoning that city officials could increase sales and property taxes.

"Even in the worst-case scenario, the median tax bill would have to increase only 15 percent (or $756) to address the pension issue fully next year," the report said.

Chicago debt is being marketed not only to investors in government bonds but also to some wealthy speculators who more typically gravitate to distressed companies. One analyst told the Tribune he is touting Chicago to his hedge fund clients as an investment less risky than troubled energy companies — and just as profitable.

These investors' gain is Chicagoans' loss. This month's two-part $1.1 billion bond deal will cost the city roughly $150 million more in interest in today's dollars than if the city still carried the A-level credit rating it had less than two years ago, the Tribune calculated.

Chicago Public Schools is likely to pay similar penalties if it follows through on plans to borrow up to $1.2 billion later this year. Some analysts have been touting CPS bonds as well, noting that while the schools' financial situation is more dire, the district's fate is largely dependent on the city that controls it.

Concord, Mass.-based Municipal Market Analytics accurately predicted in April that Chicago school bonds would drop to junk status but encouraged buyers to consider them anyway.

“The situation in the city will compromise the ability to keep quality schools, to keep the streets clean,” said partner Matt Fabian. “But for investors who can stomach the ups and downs that are probably coming for Chicago, (the bonds) give an attractive amount of income.”

The three major debt rating agencies have differing opinions on the city’s future, with Moody’s Investors Service giving the city a junk status rating and a 5 percent chance of defaulting on its loans within three years. Fitch Ratings and Standard & Poor’s maintain a low investment-grade rating of BBB+.

All three agencies cite Chicago’s estimated $20 billion in pension debt, the result of many years in which the city put off paying its full share of worker pensions. A Cook County circuit court judge on Friday struck down Emanuel’s plan to scale back benefits for some city workers.

Chicago has more than $8 billion in outstanding long-term bonds, the result of years of ambitious borrowing that included loans to pay for questionable projects and short-lived expenditures.

The city technically lacks the ability to default on that debt. Illinois, like about half of states, does not allow cities or school districts to declare bankruptcy, and a bill to change that stalled in committee this year.

Still, Chicago’s poor ratings put the city’s debt off limits for some firms. Sarasota, Fla.-based Cumberland Advisors, for example, does not buy debt rated below A.

Some less conservative investors see potential for high returns, especially if they believe the risk of default is overstated.

“Most people think it’s not a triple B credit but it’s really in the single A category,” said Jon Barasch, director of municipal evaluations at New York City-based Interactive Data, a firm that evaluates municipal bonds.

The process that sets interest rates is far from scientific. The bank underwriting the bond sale surveys investors to gauge how much interest they will demand, then works with city or school finance officials to determine what they are willing to pay in interest.

The people reaping the benefits of Chicago and CPS’ high interest payments are mostly individual investors who buy bonds either directly or through funds that invest their money. Bond dealers also buy the debt and resell it to investors.

To help local governments raise money for long-term projects, the federal government doesn’t collect taxes on most municipal bonds. As a result, the bonds appeal particularly to well-off individuals in higher tax brackets who accept low returns in exchange for a chance to preserve their wealth and reduce risk.

The $347 million in tax-exempt bonds Chicago sold July 16 offered investors yields of up to 5.69 percent — almost unheard of for tax-backed debt issued by a city.

Buyers of those bonds stand to earn at least 50 percent more than those who invested in Philadelphia bonds issued this month.

The other part of Chicago’s deal — $743 million in taxable bonds priced July 15 — caused a stir beyond the typical market for government debt.

Because officials wanted to use borrowed money to cover short-lived expenditures and close budget gaps, Chicago had to give up the federal tax exemption and offer yields approaching 8 percent — rates more typical of the corporate sector — to compensate for what investors would lose to taxes.

That put Chicago in the same ballpark as for-profit companies — a group considered far more likely to default — and even then the city's debt stood out as lucrative. The rate of return on Chicago's taxable bonds is only slightly lower than the Barclays U.S. corporate high-yield bond index, a benchmark rate of return for companies rated junk status.

"You have a very attractive interest rate for the potential risk," said Triet Nguyen, a managing director at New York City-based NewOak, an independent research and advisory firm that focuses on corporate and municipal debt.

Nguyen said he recommended Chicago taxable bonds to his hedge funds clients. His reasoning: They could earn returns more typical of junk bonds issued by troubled oil and gas companies — at much lower risk.

"I would take the credit of the city of Chicago over any of the smaller energy companies any day," said Nguyen, who lives in suburban Lake Forest. "They can certainly go bankrupt at any time, and Chicago at this point doesn't even have that option."

The additional $150 million Chicago can expect to pay through 2042 on the bonds issued this month as a result of its deteriorating credit comes on top of a similar penalty on bonds issued in May. That $674 million tax-exempt deal will cost $70 million more — in today's dollars — over the life of the debt than if the city had maintained the A3 rating from Moody's Investors Service that it carried as recently as February 2014, according to the Tribune's calculations. The city's 2015 budget is $7.3 billion.

Emanuel, who already has increased a variety of city fees, said in a plan released in March while he was running for re-election that "property tax bills will explode next year" in the absence of comprehensive pension relief from the Illinois legislature.

As with other cities, Chicago's debt contracts pledge that officials will increase property taxes "without limitation" if the city can't find money elsewhere to make debt payments.

Wells Capital Management, an investment management firm under the umbrella of San Francisco-based Wells Fargo, has increased its investment in debt from the city and CPS over the past year.

"We believe the city has the ability to raise revenue and cut expenses," said Wells Capital portfolio manager Lyle Fitterer. "If you are a citizen within the city you don't necessarily want to hear that."

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