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Hedge-Fund State Stung as Stock-Price Swings Leave Budget Gap.

Connecticut passed a budget in June that boosted funding for transportation projects, made required pension contributions and scaled back a tax increase on businesses. It appeared balanced, removing the risk of a downgrade from Fitch Ratings.

The good news didn't last long.

Four months into the fiscal year, Connecticut is facing a $118 million deficit, thanks in part to a stock-market slide that erased more than $3 trillion from share prices before it ended in late September. With just $406 million in its rainy-day fund, about one-third of the pre-recession peak, Democratic Governor Dannel Malloy and lawmakers are working this week to figure out how to shore up the finances of a state that's home to more hedge-fund money than any state but New York.

With Illinois and Pennsylvania still without budgets for the year that began July 1, Connecticut's struggle shows that passing a spending plan isn't enough if projected revenue doesn't materialize. To stabilize the state's finances, Malloy, who has already cut funding for hospitals and welfare programs, is aiming to eliminate 500 government jobs, overhaul the retirement system and change the way businesses are taxed to keep companies from leaving.

"That a budget gap has opened up so early in fiscal 2016 is definitely concerning," said Paul Mansour, head of municipal research in Hartford, Connecticut, at Conning, which holds the state's bonds among its $11 billion of local debt. "You have revenue coming in below projections, low reserves and political pressures not to cut social services. It's when you combine all these things together that you get concerned."

Connecticut is the wealthiest U.S. state by per-capita income, with an economy fueled by the finance industry. It had some 250 hedge-fund companies overseeing about $335 billion in 2013, according to the Connecticut Hedge Fund Association. Only New Yorkers rely on capital gains for a greater share of their income, said Carl Thompson, a municipal analyst in Boston at Eaton Vance Management, which oversees about $30 billion of local debt.

That leaves the government's revenue sensitive to market routs like the one in August, when the Standard & Poor's 500 index lost 11 percent in six days. The bout of selling, the worst in four years, wreaked havoc with the Connecticut's tax-collection forecasts, despite the rebound that's left stocks with gains for the year.

Rippling Down

That volatility is one reason tax collections will likely fall short of expectations, Office of Policy and Management Secretary Ben Barnes said in a letter to Comptroller Kevin Lembo last month. Lembo said the state's economy has also been restrained by the disappearance of 14,900 financial-services jobs since the recession, which has weighed on wage growth.

“Until the overall growth in the state employment numbers results in higher wage growth, which is consistent with an expanding economy, the withholding portion of the income tax will continue to present significant budget challenges,” Lembo wrote.

Municipal-bond investors are demanding higher yields to hold Connecticut debt instead of other securities. Ten-year Connecticut general obligations yield 2.61 percent, about half a percentage point more than benchmark debt. That gap is near the most since Bloomberg data begin in January 2013 and up from as little as 0.27 percentage point in January.

Stable Outlook

Fitch took Connecticut away from the brink of a downgrade in July, when it lifted the outlook on its AA rating to stable because of the balanced budget. Under that plan, Malloy kept his pledge to maintain full pension contributions. He also won a higher sales-tax rate for transportation projects, one of his biggest initiatives, and reduced business-tax increases after companies including General Electric Co. threatened to move.

Connecticut has ample time in the current year to make adjustments to the deficit, said Douglas Offerman, the Fitch analyst in New York who monitors the state. It’s easier to tweak a passed budget than govern without one, like Illinois and Pennsylvania, he said.

“This was from all perspectives a pretty decent budget that happens to be in a state that has very volatile revenue streams,” said Thompson, the analyst at Eaton Vance, which owns Connecticut bonds. “With the stock market, their revenue projections change and that can really be a very sudden, unpredictable thing.”

Faced with the latest deficit forecast, Malloy said Oct. 28 that the state should cut its workforce by 500 in the current fiscal year. Connecticut is also deferring scheduled raises for 1,600 managers and negotiating over contracts with most bargaining units, according to a presentation titled “Connecticut’s Economic and Budgetary Reality.”

Barnes, Malloy’s budget official, is involved in negotiations over curbing the deficit and wasn’t available to comment, said Christopher McClure, a spokesman for the office of policy and management. Connecticut will release new revenue estimates on Nov. 10.

“Our plan is to set priorities and make smart, pragmatic decisions about spending cuts now, so that Connecticut continues to live within its means,” McClure said in a statement.

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