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Illinois Ending Exile From Bond Market Amid Record Budget Fight.

As Illinois prepares its first bond sale in almost two years, investors say the worst-rated state in America will pay for leaving its fiscal house in a shambles.

Since it last sold general-obligation bonds in April 2014, the Illinois Supreme Court threw out the state's effort to cut workers' benefits to help close a $111 billion pension-fund deficit. Its credit rating has been cut. And temporary tax increases have expired, leaving Republican Governor Bruce Rauner and Democratic lawmakers locked in a record-long impasse that's left the state without a budget for more than six months.

The $480 million of federally tax-exempt bonds scheduled for sale on Jan. 14 will illustrate the cost of Illinois's long-building strains, which have caused investors to demand higher premiums to buy its bonds. The state's 30-year securities yield 4.67 percent, about 1.8 percentage points more than top-rated debt. That gap has risen by almost 0.7 percentage point since April 2014 and is the highest among the 20 states tracked by Bloomberg.

"They're definitely going to have to pay a higher yield," said Dan Solender, head of municipals at Lord Abbett & Co. in Jersey City, New Jersey, which manages $17 billion of the debt, including Illinois bonds. "They're going to be penalized compared to other bonds of similar ratings."

In Illinois's last sale, bonds maturing in 2039 were issued at a yield of 4.5 percent, about 2.2 percentage points more than benchmark securities, according to data compiled by Bloomberg. When they traded on Dec. 28, the difference had widened to about 3 percentage points.

Budget Battleground

The state's budget was put under strain after tax increases expired last year. Since then, Rauner, the first Republican to lead the state since 2003, and the Democrat-controlled legislature have been unable to agree on a spending plan for the year that started in July. Without action, the patchwork of measures that are keeping the government running will cause spending to exceed revenue by as much as $5 billion this fiscal year, according to bond documents.

The proceeds of the bond offering will go toward transportation projects. The securities are backed by the state's "full faith and credit" and can be paid even without a budget in place, the documents show.
"Infrastructure is critical," Rauner told reporters on Monday. "It's very appropriate that despite everything, that we continue to invest in our infrastructure, and bonding is part of that."

Rating Downgrades

While rating companies affirmed the state's grade in the run up to the sale, Moody's Investors Service cut Illinois in October to Baa1, three steps above junk. Fitch Ratings also dropped Illinois that month to an equivalent BBB+ because of the budget logjam.

Standard & Poor's, whose A- rating on Illinois is one step higher than Moody's and Fitch, on Dec. 23 removed the state from negative watch. S&P still has a negative outlook on Illinois, indicating it could still be downgraded.

"Road construction and transit improvements are key factors in growing the Illinois economy, which is why Illinois is planning a bond sale," Catherine Kelly, a spokeswoman for Rauner, said in an e-mailed statement. "There was no change in our general-obligation bond ratings from the three major ratings agencies, but they did highlight the need for long-term structural reforms to improve our fiscal outlook."

The impasse is delaying progress on Illinois's biggest challenge: its unfunded pensions. The state's four plans have less than half of what's needed to cover promised benefits. In May, the Illinois Supreme Court ruled the state's attempt to cut pension benefits was unconstitutional. Since then, partisan gridlock has kept officials from finding an alternative fix.

Illinois is going to have to price the deal "pretty attractively" in order to get a good reception from investors, said Dan Heckman, a senior fixed-income strategist in Kansas City at U.S. Bank Wealth Management, which oversees $130 billion.

"I think 2016, in our opinion, is kind of a waterfall year for the state," said Heckman. "I think credit-rating agencies are running out of patience. It will be very important and critical for the state to get its financial house in order as much as possible."

Rauner and lawmakers have been unable to agree on how to do so. In return for approving any new revenue, the Republican governor wants Democrats to back some of his proposals, such as political term limits or curbs on local property taxes. Democrats want to focus on the budget.

'Tough Votes'

Rauner said on Tuesday that negotiations are happening every week, and there's no reason a budget deal can't be concluded after the legislature returns on Jan. 13. Still, he said Democratic leaders may wait until after the primary election in March — or even the November general election — to take "tough votes."

The impasse may be affecting the state's economy, according to the Institute of Government and Public Affairs at the University of Illinois. The institute's index that tracks the growth of corporate earnings, consumer spending and personal income fell last month to the lowest since March 2013, according to J. Fred Giertz, who compiles it. The decline can't be definitely attributed to the budget standoff, but it "is likely that it is beginning to have an impact," he said in a statement.

"I don't know that we've hit the bottom," said Richard Ciccarone, Chicago-based chief executive officer of Merritt Research Services. "There's a lot of things yet to happen."

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