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Chicago Bondholders Keep the Faith After Pension Fund Setback.

Chicago's biggest bondholders aren't losing faith.

Nuveen Asset Management, Wells Fargo Asset Management, Columbia Threadneedle Investment Advisers and BlackRock Inc. are showing optimism that the nation's third-largest city will work its way out of a pension crisis, even after the Illinois Supreme Court rejected Mayor Rahm Emanuel's plan to ease $20 billion of unfunded retirement obligations. Despite a lack of help from the gridlocked state of Illinois and mounting liabilities that threaten the city's solvency, holders of more than $1 billion of the city's debt, point to Chicago's growing economy and track record of a willingness to raise taxes.

Chicago actually benefits in the short-term from last month's court ruling. Required pension payments drop by about $89 million this year, relieving some of the immediate pressure on the city budget. The two funds are still projected to run out of money in 10 to 13 years. While the decision was a disappointment, city officials now have a new set of facts to work with as they address the liabilities, said Lois Scott, Chicago's former chief financial officer.

"I almost think it's good to get this ruling out of the way, and that actually creates a little bit of clarity in terms of what their options are going forward," said John Miller, co-head of fixed income in Chicago at Nuveen Asset Management, which oversees about $110 billion in munis, including about $430 million of Chicago general obligations. "It does increase the necessity to work on a reform model that might be a little different, that might actually pass muster."

The city's most-actively traded securities over the last week changed hands at an average price of 97 cents on the dollar Wednesday, little changed from the day of the ruling, according to data compiled by Bloomberg. Spreads on the bonds that mature in 2038 had widened by 12 basis points over benchmark securities.

Confidence is being buoyed by the fact that Chicago has already shown its capacity to raise taxes specifically to pay retirement bills. In October, Emanuel pushed through a record property-tax hike to shore up the public-safety worker pensions. The move won praise from investors who rallied the city's bonds after the levies were approved.

"They've demonstrated a willingness, and they have ability, but they will continue to face budgetary pressure related to this for the foreseeable future," said Joe Gankiewicz, a credit-research analyst at BlackRock Inc. in Princeton, New Jersey, which oversees about $110 billion of municipal debt. The firm holds about $157 million of Chicago GO bonds, according to data compiled by Bloomberg, based on market value.

State Gridlock

Even with the tax hike dedicated to the public-safety retirement funds, uncertainty still haunts the police and fire pensions. State lawmakers approved legislation to lower Chicago's required payment by about $220 million this year, stretching out the amortization of the debt. Republican Governor Bruce Rauner, who received the bill on March 31, has yet to sign it.

Any kind of assistance from Springfield, the Illinois capital, doesn't look likely for Chicago. The state has its own fiscal crisis. Illinois is in its 10th month without a budget as Rauner and the Democrat-led legislature can't agree on a spending plan.

"The noise around Illinois is certainly making it more difficult for Chicago to get things done," said Dennis Derby, an analyst and portfolio manager at Wells Fargo Asset Management, which holds about $466 million, based on market value, of Chicago general obligations among its $39 billion in assets.

Liabilities Estimate

Chicago isn't alone in not having enough money to cover all the benefits that have been promised. Unfunded state and local pension liabilities total $3.5 trillion, Moody's Investors Service said in a report Wednesday. The consequences of not finding a solution are dire: unfunded pension debt helped drive Stockton, California, into Chapter 9, and Detroit into the biggest municipal bankruptcy in U.S. history. Those same unfunded obligations contributed to the crisis in Puerto Rico.

All four credit-rating companies have a negative outlook on Chicago, signaling more rating downgrades may be on the horizon. Fitch Ratings lowered the city to BBB-, one rank above junk, on March 28, calling the court's decision "'among the worst possible outcomes." A week later, Kroll Bond Rating Agency dropped its rating to BBB+, three steps above junk.

"The biggest risk is just that without the flexibility to trim benefits that it's very likely that the city's own costs will increase above those that were previously projected," said Matt Butler, the lead analyst on Chicago at Moody's Investors Service. "One of the key challenge for the city is the pace at which the pension debt continues to grow."

Credit Quality

The city has flexibility on expenditures and revenue, signaling there are options available to incorporate higher contributions over the longer-term, according to Moody's.

"Their credit quality hinges entirely on their ability to raise revenues or cut costs, and even more importantly, their willingness to do so" to pay for pensions, said Ty Schoback, a senior analyst in Minneapolis at Columbia, which handles about $30 billion in municipal bonds, including about $300 million of Chicago debt. "There is no silver bullet. It's taken years to get to this point, and it's going to take years to get out."

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