
Illinois Morass Fuels Speculation It'll Be First Junk-Bond State.

- **Gridlocked state headed to third year without a budget**
- **Rating companies warn of further downgrades without a solution**

What's worse than the worst? Illinois may find out.

The lowest-rated U.S. state is headed toward its third year of an unprecedented budget impasse as Republican Governor Bruce Rauner and the Democrat-led legislature repeatedly fail to agree on how to plug chronic deficits and halt the growing backlog of unpaid bills.

Both Moody's Investors Service and S&P Global Ratings have warned that Illinois could be downgraded again, while investors are already demanding higher yields on its bonds than they do from borrowers that are on the cusp of junk, according to data compiled by Bloomberg.

"It's getting harder and harder to find a reason to be optimistic for a budget," said Ty Schoback, a senior analyst in Minneapolis at Columbia Threadneedle Investments LLC, which holds some Illinois debt among its $22 billion of municipal holdings. "That being said, this is politics — you can't predict. Two years ago, we were debating whether or not Illinois falls into BBB. Today, we're debating whether it falls to junk status. If the status quo persists, what are we going to be debating in two years?"

The standoff has wreaked havoc on the fifth-most-populous state's finances and sunk its credit rating. Unpaid bills have soared to a record $13 billion, and entities that rely on state aid, including public universities, have had to furlough workers and cut services. A stopgap budget expired in December and a bipartisan package of tax increases and spending cuts aimed at ending the standoff fizzled in March. Illinois's leaders are at a "critical juncture," according to Moody's.

"Governor Rauner is optimistic that a balanced budget will be passed soon that will contain reforms to protect taxpayers and recruit new businesses that will boost the economy and create jobs across Illinois," Eleni Demertzis, a spokeswoman for Rauner, said in an e-mailed statement.

If an agreement isn't reached by the end of May, when the regular legislative session ends, a three-fifths majority will be required to pass anything, making a compromise even harder to reach.

Both Moody's and S&P have warned of further credit deterioration if Illinois enters a third year without a spending plan. Both companies rank Illinois only two steps above junk with negative outlooks, signaling the rating could fall again. No U.S. state general-obligation bonds have ever been rated below investment-grade, according to data going back to at least 1970.

Investors have to be prepared for the possibility, said Matt Fabian, a partner with Municipal Market Analytics Inc.

Illinois is "being managed as if it were a speculative credit," Fabian said. "It's hard to get on board and say that Illinois is a buy for anyone besides speculative investors."

Investors already demand higher yields to hold debt issued by Illinois. The state's 10-year yields have climbed to 4.3 percent, or about 2.2 percentage points more than benchmark tax-exempt debt, according to Bloomberg's indexes. That's the most of all 20 states tracked by Bloomberg and more than investors recently demanded on debt issued by borrowers with the lowest investment-grade ratings.

"Barring a comprehensive solution and a budget in place and some real concession on both sides, I think there's always room for spreads to widen," said Adam Buchanan, senior vice president of sales and trading at Ziegler, a broker-dealer in Chicago. "There is certainly room for more deterioration in their levels."

No U.S. state has defaulted on its debt since the Great Depression, and no one is expecting that from Illinois anytime soon. Illinois has been making monthly deposits to its debt service funds for its general-obligation and sales tax-backed bonds, despite the lack of a budget, according to Moody's. But without a compromise by the end of May, there's a risk of "creditor-adverse actions" like borrowing from debt-service funds, or "eventually, prioritizing core operating needs over debt service," according to Moody's.

Losing its investment-grade rating would make borrowing more expensive and limit the pool of buyers for Illinois debt, further complicating efforts to ease the liquidity crisis. The compromise that lost traction in March included a plan to issue as much as $7 billion of bonds to pay overdue bills.

The state has time to stabilize its finances. The next fiscal year begins July 1. If the two sides are able to come together operating liquidity can get restored quickly, according to Moody's. The state has the capacity to raise taxes. Its income tax rate is 3.75 percent, after a temporary hike to 5 percent expired in January 2015.

Rauner and Democrats can't agree on how to fill the hole from that lost revenue even as the state continues to spend money through a combination of continuing appropriation bills, court orders and consent decrees. Rauner, who took office in January 2015 as the first Republican to lead the state since 2003, wants any spending plan to be linked to parts of his agenda, like property-tax limits or changes in workers-compensation laws, which Democrats have resisted.

"They still have the ability to make changes should they desire to do so," said Eric Friedland, director of municipal research in Jersey City, New Jersey, for Lord Abbett, which manages about $20 billion of municipal debt, including some Illinois holdings. "But the longer this goes, the more difficult it is for them to put themselves on a good course."

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