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Why Big Bondholders are Sticking with Illinois.

(Bloomberg)—Some of the top holders of Illinois debt aren't bailing out, even as the state slides toward a junk bond rating. The reason? They say Illinois isn't an economic basket case, just the victim of a political logjam that will one day be broken.

"Illinois' problems are self-inflicted," said Guy Davidson, director of municipal bonds at AllianceBernstein Holding, which owns about \$550 million of the bonds. "They have the resources to pay their debt and we think they ultimately will."

Illinois' debt was downgraded June 1 to one step above junk by Moody's Investors Service and S&P Global Ratings, giving it the lowest ranking on record for a U.S. state, because of a clash between the Democrat-controlled legislature and Republican Gov. Bruce Rauner that's left the government without a full-year budget for nearly two years.

If the state doesn't enact a plan that reins in its chronic deficits, S&P warned that Illinois will likely lose its investment-grade status around July 1, an unprecedented step for a state that would bar certain funds from buying its securities and has stoked speculation that some investors would sell off their holdings en masse.

Fidelity Investments is the biggest public holder of Illinois general-obligation bonds, with about \$1.8 billion, according to data compiled by Bloomberg. Vanguard Group holds about \$1.6 billion, and Nuveen Asset Management about \$920 million. Three other firms—Dodge & Cox, AllianceBernstein and Wells Fargo Asset Management—hold more than \$500 million each.

BlackRock, the world's largest money manager, wouldn't have to dump its Illinois bonds if the rating is cut, a move the company sees as a strong possibility, said Peter Hayes, head of municipal bonds at the company. Illinois accounts for less than 1 percent of its \$122 billion holdings of state and local debt.

Like other money managers, Hayes sees Illinois as a state with a solid economy but serious political problems. "In that sense, it is very different from places like Detroit and Puerto Rico," he said.

While Illinois has drawn comparisons to Puerto Rico, which collapsed into bankruptcy after the U.S. gave it legal power to escape from its debt, the differences are vast. Illinois' bond debt is less than half the Caribbean island's, even though the state's population is more than three times as big.

Illinois' \$800 billion economy—more than 10 times the size of Puerto Rico's—is growing, albeit slower than the rest of the nation. It has been adding jobs, sending its unemployment rate tumbling to 4.7 percent from more than 11 percent in the aftermath of the recession. State law requires the government to appropriate sufficient money to pay debt service and it can draw from all unrestricted funds to do so. Illinois has never defaulted.

Dropping the state's already historically low rating to junk won't unleash a wave of selling, said John Miller, co-head of fixed income at Nuveen, who oversees about \$124 billion of municipals.

"Illinois' taint is a fairly well known fixture of the municipal-bond market," Miller said. "What's happening in Illinois is not being replicated across other states."

Investors have been steadily driving up the yields on Illinois bonds, relative to top-rated debt, as the state's gridlock persisted. Its 10-year bonds yield 4.5 percent, 2.6 percentage points more than those on benchmark debt. That gap, a measure of the perceived risk, is the highest since at least January 2013 and more than any of the other 19 states tracked by Bloomberg.

Illinois' plight reflects in part the expiration of temporary tax increases that helped the state deal with the toll of the recession. Facing a \$13 billion deficit in 2011, it boosted the income tax from 3 percent to 5 percent. It dropped to 3.75 percent in 2015 and officials have been at loggerheads over how to eliminate the deficit ever since.

Pushing the tax back to 5 percent would go a long way to plugging the state's ongoing deficit, said Lyle Fitterer, head of tax-exempt fixed income at Wells Fargo, where he oversees \$40 billion. Fitterer, who has held an outsized allocation of Illinois bonds for five years, said a cut to junk could be the catalyst that compels politicians to act.

"The market will ultimately force them to pass a budget or they will lose access to the capital markets," said Fitterer. "Something will have to give."

While the money managers agreed now was not the time to sell, they were divided on whether Illinois might represent a buying opportunity.

"We would not be a buyer right now," said BlackRock's Hayes. "We don't think you are being compensated for the risk at current spreads. There is more bad news to come."

At AllianceBernstein, Davidson agreed there was no rush to buy more Illinois. "We might add more if the bonds get cheap enough after a downgrade," he said.

Nuveen might add to its position, depending on how much more yields widen against other securities, Miller said.

Sophie Launay, a Fidelity spokeswoman, declined to comment. Steve Gorski, a spokesman for Dodge & Cox, declined to comment. Freddy Martino, a spokesman for Vanguard, said the company's municipal specialists said it made sense to continue holding Illinois based on their confidence the state will find a path through the budget impasse.

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