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Citigroup Sees Illinois Bonds Already Pricing In Worst Outcome.

- **Bonds have bounced back from bottom of the March selloff**
- **Bank says cut to junk possible, but there's no risk of default**

When it comes to Illinois bonds, Citigroup Inc. says the worst-case-scenario has already been priced in.

The difference between the yields on the state's debt and top-rated securities — a key measure of risk — widened to a record high in May on speculation that the financial hit from the coronavirus will make it the first state to see its credit rating cut to junk. That selloff pushed its yields to junk-bond levels, surpassing those on some debt issued by still bankrupt Puerto Rico.

But Citigroup analysts Vikram Rai, Jack Muller and Vedanta Goenka said in a note to clients Monday that a default like Puerto Rico's is not a risk since the state has many ways to contend with its tax shortfalls. That includes borrowing from the Federal Reserve's municipal lending facility, as it did last week.

Illinois bond yields surged on risk of cut to junk
The analysts' comments reflect greater optimism on Wall Street as much of the nation begins to reopen, even though record unemployment and business shutdowns are leaving governments facing massive budget shortfalls.

Illinois's bonds, which tumbled more than any other state since the pandemic spread in the U.S., have since rebounded along with the rest of the $3.9 trillion municipal market.

The 10-year bonds that Illinois sold in mid-May for a yield of 5.65%, or 452 basis points more than the benchmark, have since rallied. That bond last changed hands Friday at an average yield 4.2%, or a 340 basis-point spread.

"We believe that we could potentially see a downgrade to speculative grade though the GOs are already trading at HY spreads," the Citigroup analysts wrote. "A default, we believe, is out of [the] question and the state has already announced that it would avail itself of the Fed's MLF to address its cash flow needs. Thus, we believe that the recent tightening of spreads is reflecting the un-pricing, if you will, of the worst possible outcome."

Bloomberg Markets

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June 8, 2020, 10:30 AM PDT