# Bond Case Briefs

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## Illinois Isn't a Junk-Rated Credit. It's Just Trading That Way After Voters Rejected a Progressive Tax.

Illinois' bond prices fell after voters rejected a graduated income tax proposal on Tuesday's ballot. And while its debt hasn't been downgraded, it is already trading like junk.

Several years after its budget-setting process was frozen by political gridlock, the state has been taking steps to increase revenue and reduce its reliance on bond markets—partly because its bonds are rated BBB-, just one tier above junk.

The state's constitution mandates a flat tax, and overturning that policy would have required 60% of people voting on the amendment to approve it, or more than 50% of all voters casting ballots, according to Moody's.

Instead, about 55% of voters rejected the measure, according to the Associated Press. A graduated income tax would have brought in an estimated $1.3 billion this year, according to Fitch.

It is also looking less likely that states (or other stressed local governments) will receive substantial amounts of aid from Congress this year, as strategists say there is a higher probability of a divided government in Washington.

So Illinois' bonds have sold off. Yields of bonds maturing in five years have climbed roughly half of a percentage point since last Friday, to 3.5%, according to Bloomberg data.

The selloff has been even sharper over the past seven days, and the yields of six- and seven-year bonds have increased most on the news—the benchmark yields on Illinois' six-year bonds have climbed to 3.8% from 3% since last week.

S&P, Moody's, and Fitch all assign Illinois their lowest investment-grade rating, the equivalent of BBB-. But their current yields are closer to junk-rated municipal bonds, rather than investment-grade debt, according to Bloomberg data.

The Bloomberg Barclays High-Yield GO Index has a yield of 3.8% with a maturity of 5.4 years. The index of BBB-rated municipal bonds yields 2.6%, with roughly the same maturity.

To put it in simpler terms: The fact that Illinois' five- and six-year bond yields are trading around 3.5% and 3.8% shows that investors think the state's credit is closer to junk-rated municipals than its investment-grade peers.

"Now this is where it gets interesting, to see if the rating agencies actually have the chutzpah to pull the trigger on the first ever U.S. state junk rating," wrote Eric Kazatsky, analyst with Bloomberg Intelligence, in a Wednesday note.

To be sure, Illinois still has options to raise revenue that it can pursue during coming legislative sessions, according to a Wednesday note from Moody's.

If the state raises its flat income tax by 0.7 percentage points to roughly 5.7%, it could bring in about $3 billion of additional revenue, says Moody's, the same amount that it had projected it would raise under a proposed graduated income tax.

Gov. J.B. Pritzker has also asked state agencies to identify potential spending cuts: 5% for the current fiscal year and 10% for the coming fiscal year.

But to free up $3 billion, "the state would have to impose across-the-board reductions of almost 11%, based on actual 2019 figures," Moody's wrote. "This degree of austerity would have significant implications for delivery of core education, healthcare, corrections and other services."

It can also tap the Federal Reserve's Municipal Liquidity Facility again, says Fitch. If the state does end up getting downgraded by ratings firms, however, it will need to pay higher interest rates to use the facility.

As the state weighs its options, "Illinois' upcoming post-election legislative session could be particularly consequential this fiscal year," wrote Eric Kim, head of state government ratings at Fitch, in a Wednesday note.

**Barron's**

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