LPL RESEARCH

BOND MARKET PERSPECTIVES

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ILLINOIS ISSUES

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KEY TAKEAWAYS

Following a two-year political struggle that led to a credit rating downgrade, Illinois recently enacted a budget, temporarily easing financial stress.

Despite operating without a state budget since mid-2015, Illinois bonds have rallied after the news of an agreement in early July.

Pension funding remains a challenge for Illinois and other states, but signs of credit contagion have not materialized and appear unlikely.

The state of Illinois, facing financial challenges, is back in the news again. After two years of political infighting between the Democratic-led legislature and the Republican governor which left the state's finances in disarray, bondholders received some welcome news earlier this month when the state finally enacted a budget. Because to many this was unexpected, passage appears to have temporarily eased some pressure and bond prices have risen.

Fiscal issues in Illinois have been years in the making. Besides political infighting, excessive borrowing plagued the state leaving it unable to pay some of its bills. The state answered by deferring payments from one year to the next, resulting in $15 billion in unpaid bills, a $6 billion deficit, and an unfunded pension liability of approximately $130 billion. Cities and towns are not exempt from escalating bills, however. In 2015, Moody's downgraded the city of Chicago to Ba1 or "junk" (below investment grade) status, where it remains to this day. Although the government has tried to implement reforms and raise taxes, this only serves to reduce the population as some residents leave for cheaper states, adding to revenue shortfalls.

All is not lost yet, as Illinois has a diverse economy with high per capita income levels relative to debt. Although we think a downgrade to below investment grade is likely, the recent price improvement indicates growing confidence. We believe political pressure will eventually force politicians to work together and Illinois can then begin the long process of reducing its debt.

CURRENT PRICES INDICATE (SOME) CONFIDENCE

Given the recent difficulties in Puerto Rico, investors will be keenly aware of price weakness in Illinois and Chicago. Because we view the likelihood of default as low, pricing volatility may provide clues regarding the market perception of additional risks. Prices for Illinois state general obligation (GO) bonds have ranged from mid-$95 to mid-$102 ($100 is par value) [Figure 1]. For lower-rated Chicago GO bonds, prices have ranged from as low as $85 in 2015 to $99 more

The credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

Par value is the nominal value of a bond, share of stock, or a coupon as indicated in writing on the document specified by charter.

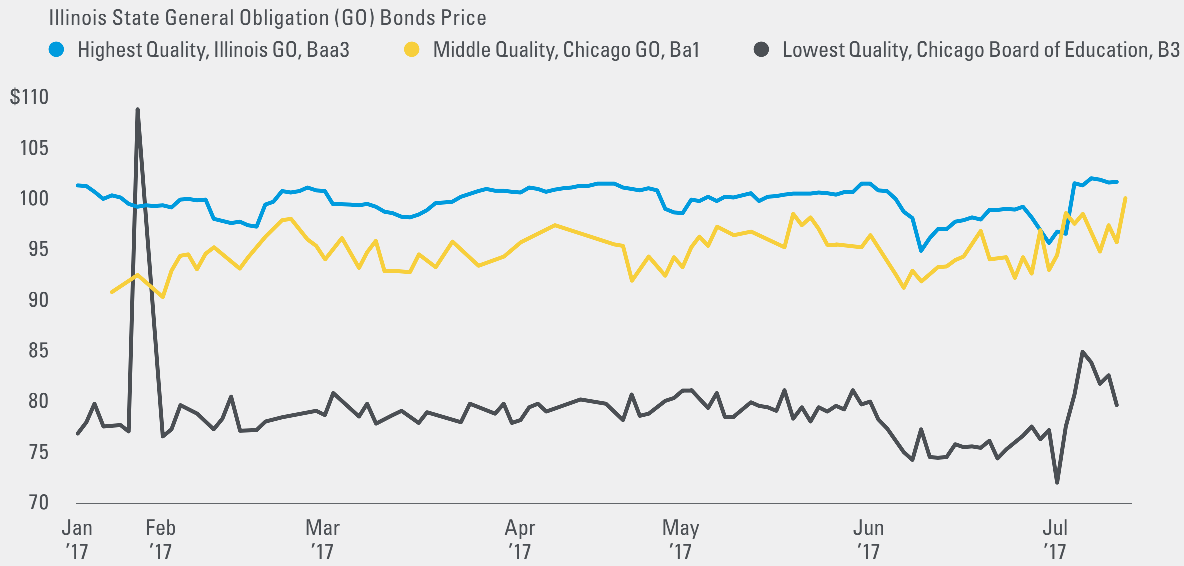
> GO bonds are typically the most senior of a municipal issuer's obligations backed by the full faith and taxing power of the issuer. The principal and interest of GO bonds are paid before other expenses and taxes are increased if necessary to pay the debt service.

recently. Currently, Chicago GO bonds trade higher than Chicago Board of Education bonds, which are priced well below par at $85. Although it is difficult to draw conclusions from this, a more thorough look at these credit ratings will shed light on the pricing differentials and some of the issues faced by these three credits.

THREE NAMES TO WATCH

- **Illinois State GO:** Currently rated one notch above investment grade, this implies average creditworthiness. A drop below investment grade would make Illinois the first state in history with a "junk" credit rating. The

1 PRICING TRENDS CAN HELP GAUGE INVESTORS' PERCEPTIONS OF RISK



Source: LPL Research, Bloomberg 07/14/17

Past performance is no guarantee of future results.

All issue names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

The Middle and Lowest Quality issues illustrated are considered high yield/junk bonds. High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

enactment of the budget should stabilize the credit until fiscal policy changes can be enacted.

- **Chicago GO:** Moody's rates Chicago GO one notch below investment grade, making it the largest U.S. city with a below investment-grade rating, implying below-average creditworthiness. Despite a record tax increase last year to shore up its finances, the city still maintains a $20 billion unfunded pension liability. Population shifts may weigh heavily on the city's ability to meet its obligations as the tax base has been shrinking.
- **Chicago Board of Education:** These bonds are currently rated below investment grade and highly speculative by all three ratings agencies. Chicago Board of Education is the nation's third-largest school district but is facing a difficult recovery as its borrowing costs have increased dramatically. On July 10, Chicago Board of Education priced a $500 million GO bond deal and the top yield came back at 7.65%, making it expensive for the school district. The organization has a long road ahead to get back on stronger financial footing.

SPILLOVER EFFECT?

Since many highly-rated states are growing their economies, Illinois is not representative of the broader municipal bond market. Growing economies have led to better credit quality metrics, and this is the primary reason why troubled municipal issuers are the exception and not the norm. Even though high-profile distressed bond issuers like New Jersey, Connecticut, Pennsylvania, and Kentucky may gather widespread attention, municipal defaults still remain isolated and minimal.

OTHER POTENTIAL PROBLEM AREAS

Illinois isn't the only municipality struggling. Connecticut, New Jersey, Kentucky, and Pennsylvania have also faced scrutiny in the past several years. Despite being one of the wealthiest states in the nation (on a per capita income basis), Connecticut's state pension problem has been in focus since 2014. More recently Standard & Poor's (S&P) downgraded Hartford, Connecticut, the state's capital, two notches to "junk" (from a BBB- to BB rating), citing "liquidity pressure." New Jersey and Kentucky remain in the news with pension funding levels below 50% (less than half the assets needed to pay liabilities), and both states are experiencing political infighting. Pennsylvania is not without its own troubles, as S&P recently warned the state to get its fiscal issues in order or face a downgrade. If downgrades persist, especially in the wealthier states, investors may reassess risks and reduce municipal bond demand.

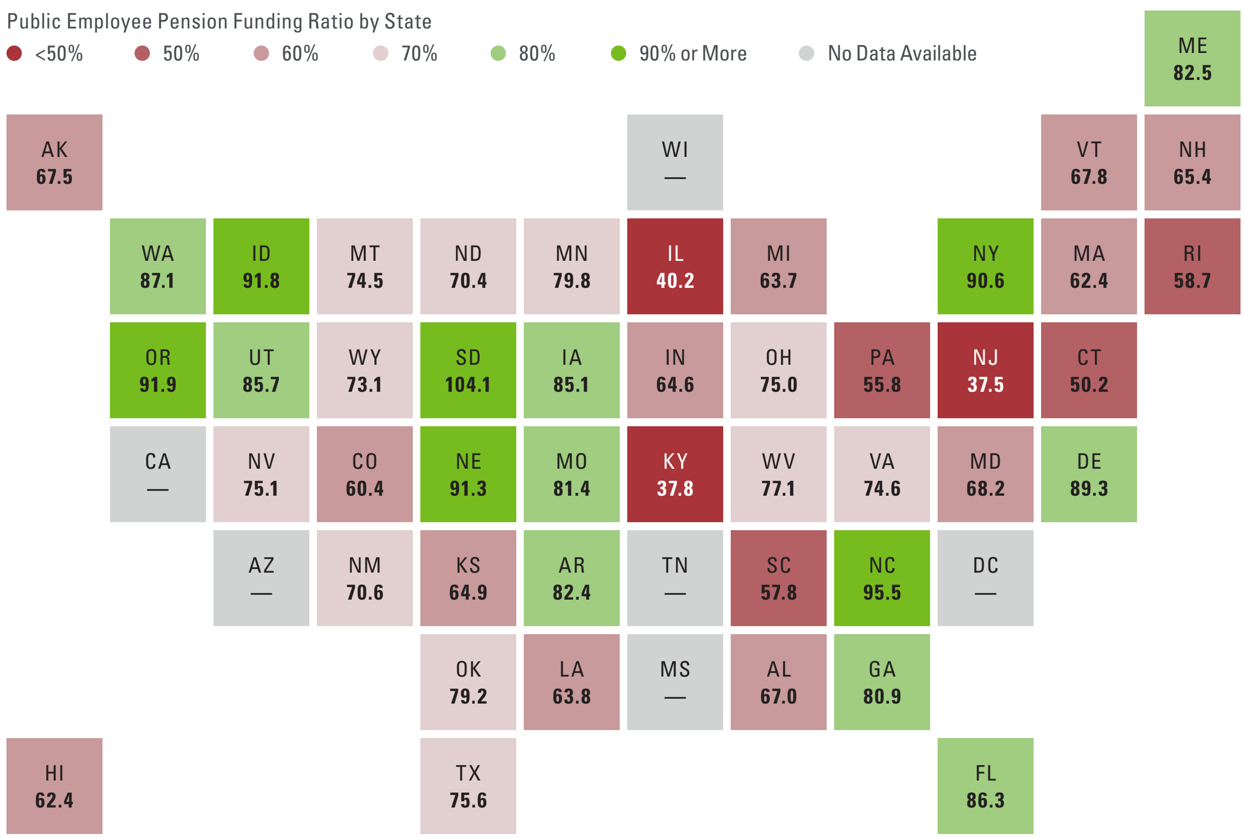
PENSION ISSUES LINGER

Another hidden risk lies in pension accounting. Many states with high pension liabilities use aggressive assumptions when calculating the expected returns of their pension portfolios. Illinois, for example, assumes 6.75% returns on its stock and bond holdings. If the market returns less for a prolonged period, pension expenses cannot be met as anticipated. Over time, this can negatively impact a state's finances. Alaska has a 67.5% funded ratio, seemingly on good footing. However, the size of their pension debt (approximately $30 billion) leaves their bonds vulnerable to weakness if their lofty 8% investment return expectations are not met. For now, stock market returns remain high, so this does not present an immediate issue. Nonetheless, we urge caution regarding states with high unfunded liabilities [Figure 2] and states that have high return expectations to go along with their high pension debt.

CONCLUSION

Illinois, its citizens, and bondholders have a difficult road ahead. The state debt level is unsustainable and real fiscal changes need to be implemented. The political turbulence may not subside, so any restructuring of debt will most likely be prolonged and a final resolution may take years. The good news for municipal investors is that the reaction in the broader municipal market has so far been muted, as Illinois' issues have been years in the making and did not come as a surprise. That said, with over $130 billion in unfunded pension liabilities, Illinois could become the first U.S. state to decline to "junk" status unless finances stabilize. The overall impact to the broader market may take time to develop, but pension liability issues across the broader market should be studied for future potential volatility. With these risks present, proper diversification to higher quality states that have well-funded pensions and realistic return expectations may minimize credit risk until the dust settles on states like Illinois. ■

2 A WIDE RANGE OF PENSION FUNDING LEVELS PERSISTS



Source: LPL Research, Bloomberg 07/14/17

All data is as of 2015 except New York, which is as of 2016.

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Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

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