Illinois lawmakers edge toward second year of budget gridlock; investors get cagey
By Gunjan Banerji
1 June, 2016

Illinois lawmakers aren't able to agree on much, but market participants may have reached a consensus on their view of the credit.

The state's official legislative session ended yesterday, 31 May, with Democrats and Republicans failing to reach a fiscal agreement for a second year in a row. Governor Bruce Rauner (R) called the spring legislative session a "stunning failure" yesterday at a news conference. The municipal market agrees, and sees the state's credit deteriorating further before any rebound, according to market participants. Moreover, Illinois' political dysfunction and strained liquidity could lead to more questionable financial behavior from the state, said two buyside analysts.

"I think it's only going to get worse," said Chris Ryon, a portfolio manager at Thornburg Investment Management, of Illinois' financial condition.

After today, the odds of reaching a budget agreement drop significantly, market participants agreed.

While the state made it from the end of FY15 to near the FY16 close without much turbulence—spreads reached an all-time high in the summer of 2015 and have slightly narrowed since—it's unclear if the end of FY17 will look as good, absent a structured fiscal plan, said a buyside analyst.

Manmade disaster

"We're like a banana republic. We can't manage our money," Rauner said at the news conference late yesterday. The governor pledged to veto any unbalanced budget, like the one Democrats proposed, which he says is USD 7.5bn out of balance.

Market participants agree that the state's financial condition is the result of deep-rooted political dysfunction rather than a financial situation truly out of lawmakers' control. But it's difficult to pinpoint when the state's ability to make good on its obligations will deteriorate in tandem with its political willingness to make the right decisions, said a second buyside analyst.

"Absent any other material developments, a breakthrough in the budget situation needs to happen before the bonds should be considered a buy," said Stephen Stowe, head of credit research at Chilton Investment Services.

Illinois general obligations (GO) are trading 160bps-170bps above the AAA MMD curve, Ryon said.

To compare, revenue bonds with a BBB rating are trading with tighter spreads than the Illinois GO, said Gregory Gizzi, a senior portfolio manager at Delaware Investments, noting that it's difficult to gauge whether further downgrades are priced in until they actually occur.

The state recently lawyered up to address five interest rate swaps with an estimated present value of negative USD 163m, according to a request for proposal. A counterparty could terminate its agreement with the state if ratings go below 'BBB' by Standard & Poor's or 'Baa2' by Moody's Investors Service, or are withdrawn completely, according to the request for proposal. Meanwhile, the 260bps letters of credit fee escalates with ratings downgrades.

Illinois is currently the lowest-rated state in the nation. Moody's assigns it a Baa1/negative rating as of 22 October 2015. S&P assigns the state an A-/negative as of 23 December, 2015. Fitch Ratings gives the state's USD 26.8bn in GO bonds a BBB+/stable rating as of 19 October, 2015.

Pushed toward bad options

"State credits typically bear little default risk given their sub-sovereign powers and considerable flexibility to manage liquidity needs," Stowe said, pointing to the **State of California**'s ability to manage its financial situation through a combination of inter-fund transfers and prioritization of debt service payments in recent years.

Pennsylvania managed to get a budget passed after many months of gridlock that resembled the current Illinois impasse, though the Prairie State's present quagmire is seen as unprecedented. Market participants said they fear the state government doesn't have the volition to guide itself back to fiscal stability.

The longer the state goes without a financial plan, the more likely it is to turn to dubious financial measures such as short-term debt, skipped pension payments, or borrowings from its General Obligation Bond Retirement and Interest Fund (GOBRI), said the first buyside analyst. The state ended FY15 with USD 454m of inter-fund borrowing, and has dipped into its sacrosanct GOBRI fund in the past, as reported.

"In the current uncharted waters, it's almost impossible to predict the level of caprice by various players," the analyst added.

While investors could swallow a cash flow borrowing aligned with a multi-year fiscal plan, such debt without a pact is not ideal, the two buyside analysts agreed. As the state's backlog of obligations grows, its GO bonds could be poised for further secondary market price volatility, the second buyside analyst noted.

"At what point are we supposed to believe you will actually get a budget done?" the second analyst asked. "You don't know where they are going."

Budget Director Tim Nuding noted on a press call last week that the state was open to a borrowing to pay down its backlog of bills in the context of a balanced budget, so that vendors could be paid. The state would need the legislature's approval to do that, Nuding said. Illinois could also refinance debt for savings, he added.

The state has USD 22.5bn in continuing appropriation items that it has no control over, including pensions, debt service, and Medicaid, said Nuding.

The state's pension payments are up to date, and there is no talk of skipping any in the near future, said Rich Carter, a spokesperson for Illinois Comptroller Leslie Munger. The state has a

USD 108.7bn net pension liability as of 30 June, 2015, alongside USD 32bn in outstanding debt, according to its 2015 comprehensive annual financial report.

Right now, the comptroller is making payments on vouchers that it received on 31 March, Carter said.

Collateral damage

Rauner proposed stopgap funding yesterday that would allow schools to open in September, and also provide appropriations to other essential government services, though lawmakers have not agreed to anything yet. The governor emphasized stopgap funding through November, acknowledging the impact that the looming election has on the lack of fiscal agreement statewide.

“There are knock-on effects of not passing a budget,” Ryon said. “It’s impacting the way we look at different Illinois credits.”

The portfolio manager noted that he is shying away from university credits within the state and taking a closer look at locals’ dependencies on state aid. If a budget doesn’t come in the near future, there probably won’t be any movement until after the November election, at which point none of the state legislators would be at risk and could afford to make difficult votes, said Dick Simpson of the University of Illinois. The lack of budget agreement also suggests that pushing through any more assistance to locals will be challenging, the second buyside analyst said.

In the meantime, “social service agencies will continue to go out of business—some universities will collapse,” said Simpson.

The state’s largest school system had a bumpy ride in FY16 awaiting USD 500m in help from Springfield. It may be poised for another, as school funding is up in the air along with the rest of state appropriations.

“As we get closer to the opening of the next school year, spreads will widen out,” Gizzi said of **Chicago Board of Education** debt in the secondary market.

Moody’s declined to comment. S&P did not respond to a request for comment.