Chilton Investment Services

Weekly Update

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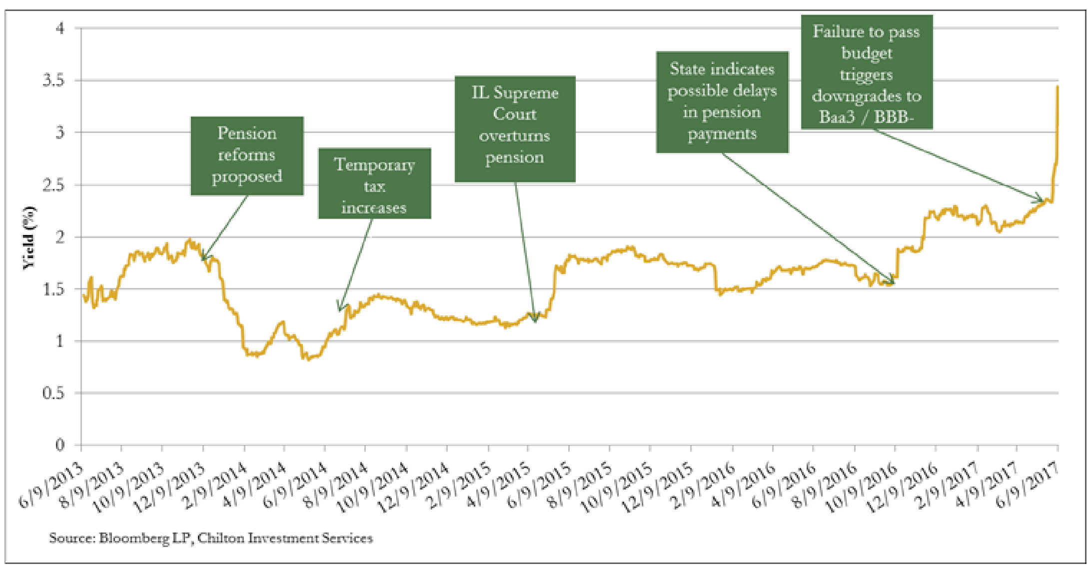
Recommend Illinois GO Bonds For Risk-Tolerant Investors

Market focus on the State of Illinois has intensified in the past 2 weeks given the State's failure to pass a budget on time, raising the prospect of the State operating without a budget for the 3rd consecutive year. On June 1st, Moody's Investors Service and Standard & Poor's downgraded the State's credit ratings to one notch above speculative grade (or "junk") status (Baa3 & BBB-, respectively).

Despite the headwinds, we believe that GO bonds continue to remain protected under a strong legal framework and the State enjoys sovereign-like fiscal flexibility. We believe the recent selloff over the past 2 weeks (since May 31st, credit spreads on 5 year Illinois GO bonds have widened ~73 basis points) has cheapened Illinois bonds to very attractive valuation levels (Chart 1).

Chart 1: Illinois Credit Spreads Widened Sharply in Recent Days Following Failure to Pass Budget



Financial Position Continues To Weaken

The expiration of temporary tax increases in 2016 and the lack of any approved budget for the past 2 years resulted in the State's largest operating deficit in 5 years at just over 7% of budget in fiscal 2016. The primary driver for the deficit was a 23% decline in income tax revenue due to expiration of temporary tax rate hikes implemented in 2011. This budget gap remains unaddressed and unaudited figures for fiscal year 2017 show revenue continuing to slide, down 3.5% through 11 months of the fiscal year although it should be noted that the trend has reversed in the most recent 3 monthsi. The State has increasingly resorted to deferring expenditures and the accounts payable has ballooned to $14.9 billion from $7.7 billion a year ago. Expectations for the next fiscal year (FY18) show continued weakness with payables projected to rise to $22 billion, representing an extremely high 68% of projected revenues. Finally, the State's credit profile remains severely burdened by its 35% pension funding ratio with a combined unfunded liability of $141 billion.

Lawmakers now have until the end of June to come to a budget agreement before the start of the next fiscal year. Both sides are reportedly still in touch and we expect headlines throughout the next two weeks. As the Legislature is now operating outside the regular legislative session, a supermajority of 60% is required to approve any budget or override the Governor's veto. We believe this margin will be surmountable in the event a true compromise bill is negotiated.

Legal Protections Remain Sound

It is highly unlikely revenues could ever decline enough to jeopardize debt service and the requirement to fund debt service a year in advance provides assurance. The General Obligation Bond Act establishes the General Obligation Retirement and Interest Fund (GOBRI), which is a separate fund within the State Treasury into which debt service deposits are deposited on a monthly basis. GO bonds also have first claim on General Fund revenues to pay debt service. Finally, the legal language contained in the General Obligation Bond Act directly implicates the Governor, Comptroller and Treasurer if debt service is not paid. The State collects ~$30 billion in revenue and has annual General Obligation debt service payments of ~$3.5 billion. Short of a complete evaporation of the revenue base, there is ample ability to pay debt service.

Base Case

The next statewide election is in November 2018 and it is very likely that election politics will lead to another year of "muddling through", likely in the form of a partial, maintenance budget passed by July 1st, similar to last year. This would fund areas such as K-12 education and debt service for the following fiscal year. This last point bears emphasizing – the State is legally required to pre-fund debt service a year in advance. In other words, as of this publication date, funds have already been set aside for debt service due in the upcoming fiscal year, even though an operating budget has not been approved. In line with recent budget decisions, we assume the State funds 100% of K-12 education and debt service and defers all other expenses by 35%. This provides revenue available for debt service of $5.6 billion in fiscal 2018 which in turn provides 1.7x coverage of fiscal 2019 debt service (Table 1). Under this scenario, revenues would have to fall an additional 7% to jeopardize debt service, a scenario we view as unlikely given the modest 2.5% growth rate of the Illinois economy.

Table 1: State of IL General Fund Cash Receipts and Disbursements

State of Illinois	Cash Basis			Projected		
	Jun-14	Jun-15	Jun-16	Jun-17	Jun-18	Jun-19
GF Revenues	36,768	36,735	31,042	32,436	32,492	33,972
- % Change		-0.1%	-15.5%	4.5%	0.2%	4.6%
K-12 Education (100% funded)	6,679	6,621	7,094	7,461	7,610	7,762
All other expenses (65% funded)	18,142	18,771	14,089	18,403	19,312	20,262
Revenues available for DS	11,947	11,343	9,859	6,572	5,571	5,948
Debt Service Expense (100% funded)	3,646	4,082	3,425	3,617	3,488	3,356
Gross DSC	**10.08**	**9.00**	**9.06**	**8.97**	**9.31**	**10.12**
Net DSC		**2.93**	**3.31**	**2.73**	**1.88**	**1.66**
Annual deficit / deferrals	-1576	585	3954	5687	7246	7053
Payable balance	4,604	5,189	9,143	14,830	22,076	29,129
As % Revenues	13%	14%	29%	46%	68%	86%
Credit Ratings (MDY/S&P)	A3/A-	A3/A-	Baa2/BBB+	Baa3/BBB-		

Bloomberg LP & Chilton Investment Services

Optimistic case

There is evidence that the contours of an eventual deal are becoming slightly more visible. In the latest round of budget negotiations, media reported the Governor has accepted the principle of income and sales tax hikes provided the budget included certain legal, labor and budget reforms as well as a 4 year property tax freeze. The Senate passed a compromise bill reflecting many of the Governor's proposals but the Governor declined to support the bill as he believed the measures did not go far enough (i.e. - the Senate only proposed a 2 year property tax freeze). Meanwhile, Democrats in the House of Representatives have been split with many reluctant to voice their support for tax hikes in the absence of clear support from the Governor. As a result, while Democrats control the House, there was little incentive to produce a compromise budget of their own.

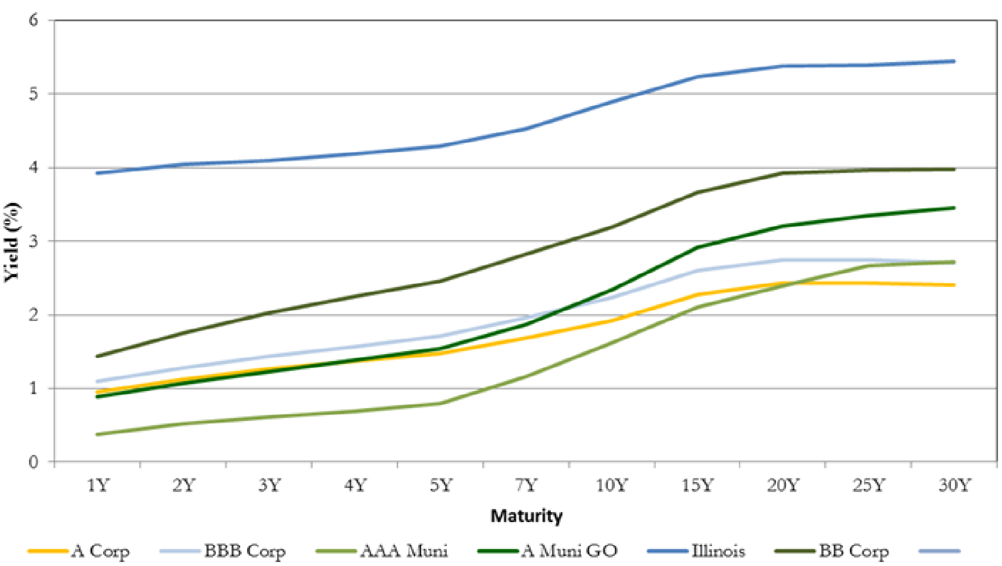
A powerful incentive exists in the form of possible additional credit rating downgrades with S&P indicating a drop into speculative grade status could occur if a budget is not adopted by July 1st. Following the state legislature's failure to passing an on-time budget for the third straight year on May 31st, both Moody's and S&P downgraded the State to one rating notch above speculative grade (ie – "junk") territory, an unprecedented level for any U.S. State since the Great Depression.

Success will depend on political courage and right now neither Governor Rauner (R) nor House Speaker Michael Madigan (D) has an excess of political capital. Disapproval ratings for both men are approximately 60%. Senate President John Cullerton (D) enjoys a somewhat more positive reputation with "only" a 39% disapproval rating and has sought to position himself as a mediator as a chief architect of the now-failed "Grand Bargain" budget proposal. A potential compromise could see Cullerton and House Minority leader Jim Durkin (R) working together in some fashion to bridge the gap between their 2 parties.

Worst case

In the event political conditions worsen and the recent modest economic recovery reverses, the State's cash position would be even more heavily scrutinized. Total cash balances in all funds is estimated to equal $6.33 billion at the end of the current fiscal year though just $133 million is in the General Fund. The State Controller has authority to shift cash on a temporary basis between the General Fund and other funds, enabling the State leeway to meet daily liquidity needs. Importantly, these figures are expected to remain stable as any expenses that can't be paid on a cash basis are simply deferred. In addition, in the event external financing was required, we believe the State would be able to maintain market access either via the bond, bank or private loan markets. Evidence of this relationship was demonstrated this week when Barclays Bank PLC, JP Morgan Chase & Co. and Bank of America agreed to modify the terms of their interest rate swap agreements with the State, lowering the rating credit threshold required under the deal. While this method of operating is not ideal, it also is not unprecedented – witness the State of California's cash management, use of IOU's and external financing employed at the peak of their fiscal crisis in 2009-2010 when the State was lowered to triple-B ratings by at least one rating agency. California has since recovered to double-A ratings though the pension system in California was never as weak as the situation in Illinois. Furthermore, while Illinois' borrowing costs are set to rise, the State has taken debt management actions over the past year that has resulted in a lower near term debt maturity schedule. Finally, we believe the growth in the State's accounts payable will serve as a powerful additional incentive to negotiate a balanced budget.

Chart 2: IL Offers Strong Relative Value, Trading Cheaper than High Yield Corporate Credit *



Source: Bloomberg & Chilton Investment Services

* Tax Adjustment, assuming 39.6% tax rate

So what should an investor do? If risk tolerance allows, buy Illinois G.O. bonds

For those investors with appropriate risk tolerance, we advocate adding Illinois General Obligation exposure given the State's inherent credit strengths (sovereign-like fiscal management powers, large economy, strong legal protection for bondholders) and very attractive relative pricing levels. While it is likely that the State may be downgraded to speculative grade status in the near term, we believe that this is largely factor into current bond valuations (Chart 2) which imply weaker credit quality than single-B corporate bonds. As mentioned throughout this piece, while the State finds itself in a very challenging situation, we believe markets have overreacted and that GO bonds will pay principal and interest in full.

[i] Monthly Briefing For The Month Ended: May 2017, Commission on Government Forecasting and Accountability, May 2017; http://cgfa.ilga.gov/Upload/0517revenue.pdf