**Illinois**

**Investment Category:** Aggressive Income  |  **Sector:** Various

**Municipal Bond Research** Tom Larm, CFA  
**September 21, 2018**

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**Sell**

**Recommendation**

We recommend Edward Jones’ clients sell these bonds. We believe that bonds backed by Illinois are not an appropriate fixed-income holding because, in our opinion, they offer an unattractive risk/reward scenario at current prices.

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**Edward Jones Credit Strength Assessment**

<table>
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<tr>
<th>Low</th>
<th>Below Average</th>
<th>Average</th>
<th>Above Average</th>
<th>High</th>
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**Investment Summary**

We believe the strengths of Illinois' demographics and economy are more than offset by the state's large pension liabilities, weakened financial flexibility, and political uncertainty, even following multiple steps taken to alleviate pressures. In our view, political risk is high, even after the end of the long budget impasse. Illinois residents have among the highest tax burdens in the nation. Taxes are rising, the population is falling, and the economy is growing relatively slow, which make it more difficult for Illinois.

Illinois' ability to raise revenue and cut expenses serve as stabilizing factors, but we do not believe the state can depend on these options alone. Options to lower pensions, one of the state's greatest challenges, are more slim given their constitutional protections. Pension and debt payments make up a high percentage of the state's budget. High fixed costs are hard to maintain, and would become harder to maintain if the economy weakens. Further limiting financial flexibility are that Illinois' reserves are low and unpaid bills are high when many other states are building reserves to prepare for the next downturn.

While we view recent tax increases positively, we also believe additional reform and more time is needed to alleviate long-term pressures and improve flexibility. Without more steps towards stabilization, we expect increased default risk, high headline risk, volatile bond prices, and more credit downgrades, even to below investment grade. The risks to our opinion are that the economy speeds up, the state finds a way to sufficiently cut pensions, and/or lawmakers compromise and implement a realistic package of reforms.

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**Bond Strengths**

- Ability to increase taxes and adjust spending
- A large and diverse economy that's growing, though slower than the nation

**Bond Weaknesses**

- Large backlog of unpaid bills
- Large and growing pension and debt obligations
- Increased political uncertainty

*The opinion also applies to insured bonds, but not prerefunded bonds. We based our opinion off Illinois' underlying credit quality.*

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**Related Bonds Include**

General Obligation (GO), Dedicated Tax Revenue Bonds, Civic Center Bonds, Metropolitan Pier and Expo Authority, and Sports Facilities Authority

**Underlying Credit Ratings**

- Moody's: Baa3 Stable Outlook*
- S&P: BBB- Stable Outlook*
- Fitch: BBB Negative Outlook*

*GO rating. Other bond ratings may differ.

**Financial Data**

- **Pension Funded Level:** 40%
- **Direct Debt per Capita:** $2,400

Average State Pension Funded Level is 70%. Average Direct Debt Per Capita is $1,006.

**U.S. Recommended Municipal Bond Sector Weightings**

- **General Obligation** (30%-80%)
- **Revenue Bond - Tax-Backed** (5%-20%)
- **Revenue Bond - Utilities** (10%-25%)
- **Revenue Bond - Transportation and Other** (5%-20%)
- **Revenue Bond - Education** (0%-10%)
- **Revenue Bond - Health Care** (0%-5%)
- **Revenue Bond - Housing** (0%-10%)

**U.S. Recommended Bond Ladder**

- **Short-term (up to 5 years)**  
  - 30%-45%
- **Intermediate-term (6-15 years)**  
  - 40%-50%
- **Long-term (16+ years)**  
  - 15%-25%

Please see important disclosures and certification on page 4 of the report.
Recent News and Analysis

7/19/2018: Moody’s revised the outlook on the state of Illinois to stable from negative. Moody’s highlighted the benefits of Illinois’ recent income-tax increase and its belief that fiscal risks in the near term are manageable. Despite these improvements, the rating agency also highlighted the state’s underfunded pensions as a somewhat offsetting factor for the rating.

6/1/2018: The state legislature has passed a budget for fiscal year 2019, which the governor has said he will sign. By doing so, the state has avoided having another budget impasse as has happened in recent years. While we view the passage of a budget on time positively, we believe the state will remain in a weak position financially. Similar to our thoughts on last year’s budget-related legislation, this year’s legislation includes certain provisions, such as interfund borrowing, asset sales, and voluntary pension reform, that increase the uncertainty of successful implementation and aren’t necessarily sustainable in our view. Furthermore, we believe more action will be needed to fix the state’s pension challenges, improve reserves, and pay down the large backlog of unpaid bills in order to enhance financial flexibility.

Municipality Outlook

Illinois’ Large, Diverse Economy Is Growing, but Slowly

Illinois, with a population of nearly 13 million people, is the fifth-largest state in the nation. The state enjoys a large and diverse economy, which is also the fifth-largest in the nation. Being the home of a national economic center, many Fortune 500 companies, and a relatively highly skilled workforce, Illinois’ economy enhances credit stability.

However, the economy is growing slower than the national average, and the unemployment rate has recently been among the highest in the nation. Furthermore, the Bureau of Economic Analysis reports that the state’s population has declined over the past three years while the United States population has grown. Additionally, over the past five years, the state’s personal income has grown by 2.9%, on average, which is slower than the nation’s 3.4% growth. In our view, these measures are concerning considering we believe the state needs to raise taxes and cut spending, which we would expect to put more downward pressure on economic and population growth. A growing economy is important for the state to be able to meet growing financial obligations.

Bond Payments Highly Prioritized

A strength of Illinois bonds is that the state puts a high priority on bond repayment, with general obligation bonds carrying a stronger security and priority than appropriation bonds. However, we expect even general obligation bonds to be negatively impacted by Illinois’ credit deterioration and face an increased risk of default. We consider bond payments a fixed cost for the state, which limits financial flexibility. The state government has found it difficult to operate under its high fixed-cost structure, and the difficulty will increase if the economy weakens.

Ability to Adjust Budget

Illinois has the ability to raise taxes without voter approval, which enhances financial flexibility. When the state used this ability to increase income taxes in 2011, the increases partially expired and taxes were lowered in 2015. Allowing the income tax increase to expire lost the state about $5 billion per year, or 15% of 2014 revenue, which is the last full fiscal year the tax increase was in effect.

Unpaid Bill Backlog Remains High

The state increased taxes again in July 2017, and this time the higher income taxes are permanent. The tax increases are expected to bring in an additional $5 billion for the state. While we view the additional revenue positively, we do not believe the tax increases solve all the state’s financial pressures. Additionally, in our view, the state will be less willing to implement further tax increases going forward due to the ongoing politically charged debates, and due to the tax increases that are being implemented and/or proposed by other municipalities across the state. Illinois residents already have among the highest tax burdens in the nation, according to the Tax Foundation.

Illinois leaders also have the ability to make certain spending cuts to more closely align revenue with expenditures, and they’ve taken significant steps to do so. The approved 2018 budget cut about $2.5 billion in spending relative to previous years. However, the budget is based on certain assumptions and faces implementation risks, which keeps uncertainty elevated as the state may continue to face future deficits.

Unpaid Bill Backlog Remains High

The combined effect of lower tax revenue and growing expenditures, such as for pensions, led to a significant budget imbalance, which resulted in a large backlog of unpaid bills. In fiscal-year 2018, the backlog grew to over $16 billion, or about 50% of state revenue sources. Planned as part of the budget impasse resolution, Illinois borrowed money, used cash on hand, and used funding from federal sources to pay down a portion of the bill backlog. Even after the plan was implemented, which increased the state’s debt levels, Illinois could have $7 billion-$8 billion of unpaid bills, or more, by the end of the fiscal year.
While the ability to delay certain payments demonstrates an added level of financial flexibility for the state, we view the size in unpaid bills as a key bond challenge. At this point, it's uncertain whether the state can prevent bills from growing even after paying down a significant portion. Although state leaders have taken steps towards aligning the budget, such as by raising taxes, they have also decided to deplete certain reserves and delay spending, which we view as unsustainable. At this point in the market cycle, with the economy years into its recovery, states typically build reserves to prepare for the next downturn. Conversely, Illinois planned to dry up its rainy-day fund this year. Given the large bill backlog and low reserves, we expect Illinois' financial pressures to take years to correct, with volatile bond prices and credit ratings along the way.

The Pension's Crowding-Out Effect

The state’s pension is currently less than 40% funded, meaning its cash and investments amount to only 40% of what it's expected to owe beneficiaries over time. The average funding level for a state is about 70%. Debt and annual pension payments have continued to consume a significant portion of the budget. Illinois' pension payments are more than 20% of its budget. The average pension costs for states is closer to 5% of the budget. Pension payments are expected to grow over time and crowd out funding for other purposes, such as public safety, education and health care, but they are expected to remain below an amount that's likely needed to bring down the unfunded liability. Such high fixed costs significantly limit flexibility.

Given the budget pressures mentioned above, we do not believe Illinois can depend on tax increases or spending cuts alone to align revenue with expenditures. Rather, state lawmakers will need to implement pension reform and minimize the fixed-cost impact to the annual budget. However, with strong constitutional protections confirmed by the state supreme court, the state government's ability to cut pension liabilities has become more limited. We question the ability of lawmakers to come to an agreement on a sufficient package of revenue enhancements, spending cuts, and impactful pension reform without first facing additional credit deterioration and further increasing the risk of bond defaults. Therefore, we expect lower bond prices and additional credit downgrades, even to below investment grade. Bonds issued by the state of Illinois backed by annual appropriations already carry below-investment-grade credit ratings.

Edward Jones Credit Strength Assessment

We believe Illinois has a low credit strength assessment due to increased political uncertainty that has delayed action on rising post-employment obligations and other financial pressures. We believe the state has become less willing and able to implement the changes necessary to prevent further credit deterioration, which increases the risk of default.

Valuation is based on our analysis of credit spread - which can be described as excess yield - relative to bonds of comparable quality and term to maturity.
Required Research Disclosures

### Appropriate for Income

Appropriate for Income – We consider bonds to be an appropriate holding for investors seeking income within a well-diversified portfolio. Our time horizon is 3-5 years.

### Appropriate for Aggressive Income

Appropriate for Aggressive Income – We consider bonds appropriate only as a small Aggressive Income portion within a well-diversified portfolio. Bonds within this category are riskier, with a higher possibility of loss due to default, than bonds classified as Income. Our time horizon is 3-5 years.

### Sell

Sell – We recommend investors sell these bonds. We believe these bonds are no longer an appropriate fixed-income holding because, in our opinion, they offer an unattractive risk/reward scenario at current prices. Our time horizon is 3-5 years.

### FYI

FYI - For informational purposes only; factual, no opinion.

Initiated Coverage (Appropriate for Income) 11/29/12...(Appropriate for Income) 11/29/12-8/24/16...(Sell) 8/24/16-

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- Edward Jones Credit Strength Assessment: Low – Our opinion is these credits are of low financial quality. We believe these credits are the most likely to default and experience the most financial hardship. Below Average – Our opinion is these credits are of below-average financial quality. We believe these credits are more likely to default or experience financial hardship than the average. Average – Our opinion is these credits are of average financial quality. We believe these credits have a low probability of default or low chance of experiencing financial hardship. Above Average – Our opinion is these credits are of above-average financial quality. We believe these credits are less likely to default or experience financial hardship than the average. High – Our opinion is these credits are of the highest financial quality. We believe these credits have the lowest probability of default and will experience the least financial hardship.
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