Illinois
Investment Category: Aggressive Income | Sector: Various

Municipal Bond Research  Tom Larm, CFA  July 20, 2017

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.

Edward Jones Credit Strength Assessment

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 long budget impasse, which demonstrates the difficult policy decisions lawmakers face. Illinois residents have among the highest tax burdens in the nation. Taxes are rising, and the economy is growing relatively slow, which makes 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.

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

Bond Challenges
- 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.
Recent News and Analysis

7/20/2017: Moody’s has confirmed the state’s general obligation bond rating at Baa3, and Moody’s placed the rating on negative outlook. The rating confirmation demonstrates Moody’s belief that the budget alleviates immediate liquidity pressures, moves the state closer to fiscal balance, and keeps fixed costs manageable in the near term. However, similar to Fitch’s recent comments, Moody’s remains concerned with implementation risks, continued pension liability growth, and the state’s vulnerability to economic downturns.

7/17/2017: Fitch has affirmed the state’s general obligation bond rating at BBB, and Fitch placed the rating on negative outlook. The confirmation reflects Fitch’s view of the state’s actions to more closely align revenue with spending, which decreases the likelihood of a liquidity crisis. However, as demonstrated by the negative outlook, Fitch remains concerned with the state’s ability to successfully implement the budget, especially given the elevated political risks.

7/12/2017: S&P has affirmed the state’s general obligation bond rating at BBB- and appropriation bond rating at BB+. The outlook was revised to stable. S&P believes the passage of the budget decreases the likelihood of a liquidity crisis in the coming months, and that the spending and revenue adjustments are favorable. The rating outlook assumes successful implementation of the budget legislation. However, S&P warned that the state’s backlog of unpaid bills, severely underfunded pensions, and political uncertainty, among other credit factors, continue to weigh on the rating.

7/6/2017: Today, Illinois lawmakers in the House of Representatives plan to vote on whether to override the governor’s veto of three budget-related bills, including a spending plan and a tax increase. The bills originally passed with veto-proof majorities. If the House successfully overrides the governor’s veto, the state’s budget impasse will come to an end after more than two years without a budget.

At various points this week, all three rating agencies have commented on the progress and the importance of passing a budget, but only one has taken rating action. Moody’s has placed the state under review for possible downgrade. According to Moody’s, the rating action incorporates the expectation that the legislature will implement revenue increases, but Moody’s believes the plan entails substantial implementation risk. Furthermore, Moody’s states the plan appears to lack measures to sufficiently address other key challenges, such as large unfunded pension liabilities and a backlog of unpaid bills.

Reportedly, the plan estimates spending around $36 billion, down from about $39 billion being spent without a budget. Tax increases are estimated to bring in an additional $5 billion. Previously, the state’s revenue totaled $32 billion-$33 billion. The plan also calls for paying down a portion of the state’s unpaid bills and makes some changes to pensions, among other provisions.

While we would view the end of the budget impasse and the passage of a tax increases positively, we believe the state will remain in a weak position financially whether Illinois lawmakers vote to override the governor’s veto this afternoon or not.

Assuming the plan is implemented as outlined, the state will continue to have billions of dollars in unpaid bills and weakened financial flexibility. At this point in the economic cycle, most other states have been able to pay down bill backlogs and build reserves in preparation for the next downturn. Furthermore, although some pension changes have been included in the plan, we expect more pension changes are needed to fix the state’s significant unfunded pension liabilities, which rank among the worst in the nation. Lastly, the plan is based on certain assumptions, such as pension savings and revenue growth, which increase the uncertainty of successful implementation. We continue to believe clients should sell bonds issued by the state of Illinois in favor of stronger credits.

6/1/2017: S&P downgraded the state’s general obligation bonds from BBB to BBB-. Appropriation bonds were also downgraded and are now rated below-investment-grade at BB+. S&P placed the state on CreditWatch with negative implications and set the expectation that the rating will be lowered again in July if lawmakers don’t pass a budget with provisions that place the state on a more sustainable path.

Moody’s also downgraded the state’s general obligation bonds from Baa2 to Baa3. Appropriation bonds are now Ba1. Moody’s maintained the negative outlook.

The rating actions come a day after the end of the state’s regular legislative session, which is the deadline to pass a budget without higher voting requirements. The downgrades were driven by the state’s growing budget deficit, significant backlog of unpaid bills, high fixed costs, depleted budget reserves, and inability to adequately fund public services, among other reasons.

The downgrades demonstrate our view that the state’s credit quality is deteriorating. The longer lawmakers take to place the state on a more sustainable financial path, the more difficult the problems will be to fix. Political risks remain high, especially as we enter more into the state’s 2018 election cycle. While it’s uncertain when lawmakers will pass a budget and what that budget will look like, certain provisions that have been included in recent debates are likely to face legal challenges and/or may not do enough to fix the state’s longer term challenges. We continue to believe Edward Jones clients would benefit from selling bonds backed by the state of Illinois in favor of stronger credits.

3/2/2017: Movement in the Illinois Senate to pass a budget (referred to as the "grand bargain") stalled yesterday as key votes that had been scheduled were cancelled. The future of the grand bargain has grown increasingly uncertain. Passage of the grand bargain has now been delayed multiple times, and the next step towards a compromise remains to be seen. Without a solution to the current budget impasse that also includes changes that place Illinois on a more sustainable financial path, we believe the state will continue to deteriorate and additional credit-rating downgrades will become more likely, especially since political risks remain high for bondholders.

2/1/2017: Fitch downgraded the state’s general obligation bonds from BBB+ to BBB. Appropriation bonds are now rated BBB- by Fitch. Fitch maintained the negative watch.
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 two years while the United States population has grown. Additionally, over the past five years, the state’s personal income has grown by 3.3%, on average, which is slower than the nation’s 4.2% 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.

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 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. Following the passage of the stopgap budget on June 30, 2016, the Commission on Government Forecasting and Accountability projected the budget gap grew from nearly $4 billion in fiscal-year 2016 to nearly $8 billion in fiscal-year 2017.

To date, state leaders have 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.

The state’s budget deficits have resulted in a large backlog of unpaid bills. At the end of fiscal-year 2017, the backlog is estimated at around $15 billion. As part of the recent budget impasse resolution, Illinois plans to borrow money, use cash on hand, and use funding from federal sources to pay down a portion of the bill backlog. Even after the plan is implemented, which will increase the state’s debt levels, Illinois could have $7 billion-$8 billion of unpaid bills, or more. 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 once a significant portion is paid off. 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

Illinois has been underfunding its pension for decades, and it is currently less than 38% funded, meaning its cash and investments amount to only 38% of what it's expected to owe beneficiaries over time. The average funding level for a state is about 70%. The liability has grown significantly over time and now stands at nearly $130 billion, which by many measures is very weak for a state. When pension obligations are viewed together with about $33 billion in debt, billions in unpaid bills, and $35 billion in other post-employment benefit obligations, financial-leverage measures weaken even further.

Although the funded ratio seems to have stabilized, debt and annual pension payments have continued to consume a growing 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 what actuaries recommend in order 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 to lower pension liabilities and minimize the fixed-cost impact to the annual budget. However, with strong constitutional protections that were confirmed by the state supreme court in recent months, 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.

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.
Required Research Disclosures

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<th>Appropriate for Aggressive Income</th>
<th>Sell</th>
<th>FYI</th>
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<td>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.</td>
<td>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.</td>
<td>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.</td>
<td>FYI -- For informational purposes only; factual, no opinion.</td>
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