Illinois, New Jersey, and Pennsylvania present new calculus for relative value trades
by Gunjan Banerji and Maria Amante
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It's a story of bad, worse and worst when comparing **Pennsylvania**, **New Jersey** and **Illinois**, said Chuck Grande, executive director and head of credit research at UBS.

While all three states have endemic structural imbalances in common, alongside deep pension issues, the market appears to prefer the hairy Illinois paper, while recalculating its view of Pennsylvania risk.

"Pennsylvania is really good for Illinois, and Illinois is really bad for Pennsylvania," said one buyside analyst, regarding the market optics of the two states' budget delinquencies.

The Keystone State's debt is trading 63bps above the AAA MMD, while Illinois' trades around 165bps above the AAA MMD, according to a municipal bond trader. New Jersey's debt is nestled in between the two, trading 94 bps above the AAA MMD, the trader said.

Both Illinois and Pennsylvania continue to operate without budget agreements with just over three months remaining in FY16. New Jersey has a budget, and not much else. Weighing the unlikelihood of a state default in the municipal market, investors jump for the debt yielding the most – in this case, Illinois'.

Illinois remains the clear opportunity among the three states, agreed Belle Haven Investments' Tamara Lowin and Baird Advisors' Duane McAllister. Spreads on Pennsylvania and Illinois debt could move closer to each other over time, McAllister, who is a senior portfolio manager at the firm, said. Because spreads have not widened out in Pennsylvania as much, there is less upside, McAllister added.

But not all are sold on the trade.

While there may not be looming default risk associated with Illinois' bonds, the prospect of further spread widening is very real, said Joe Baxter, a senior portfolio manager at Delaware Investments, who doesn't own the bonds. The portfolio manager has also been decreasing his exposure to Pennsylvania general obligation (GO) debt, which could cheapen, according to him.

Moody's rates Illinois' USD 26.5bn in outstanding GO debt Baa1/negative, while Standard & Poor's gives it an A-/negative rating. Moody's gives Pennsylvania's USD 10.9bn in GO debt an Aa3/negative rating while S&P gives it an AA-/CreditWatch with negative implications. New Jersey has USD 2.2bn of GO debt, rated A1 by Moody's and A/stable by S&P, and USD 30bn of appropriation debt.

Pensions weigh on states

Pennsylvania's pension problems and aging demographics hold the state back, Lowin said, adding that the state's ratings could be inflated. The commonwealth needs more than just an approved budget, it needs an overhaul.

While raising taxes hasn't proven politically easy in Illinois and Pennsylvania, many claim that there is room to do so. Market participants point to Illinois' temporary income tax, which faded on 1 January 2015, as a source of new funds for the state. Without the tax, Illinois continues to spend more than it rakes in, accumulating a USD 7.5bn backlog of bills as of 15 March.

All three entities, which have ratings below the median-state rating, have large unfunded pension liabilities weighing on their balance sheets and being fought in state courts and legislatures. Illinois' is the largest—a 41% funded ratio with a staggering USD 111bn unfunded pension liability —and the state also has the least flexibility to taper this liability because of a State Supreme Court ruling deeming its prior pension reform unconstitutional.

Pennsylvania's biggest pension funds have funded ratios spanning 59%-62%, with a cumulative USD 53bn unfunded liability. New Jersey plans have an aggregate 48.6% funded ratio and USD 43.8bn unfunded liability.

New Jersey's challenges don't appear to be subsiding anytime soon, but it did receive a boon from the rating agencies after a February high court decision on pensions. The state court sustained Governor Chris Christie (R)'s discretion on whether he had to fully fund the state's contributions to its retirement systems—a move considered a "credit positive" by Moody's.

Municipalities tied to their sovereign

The Illinois and Pennsylvania budget impasses weigh heavily on their municipalities, Baxter said. In Illinois, first-term Republican Governor Bruce Rauner is facing off against a Democratic legislature, while in Pennsylvania, first-term Democratic Governor Tom Wolf continues to clash with the Republican legislature.

And for the Midwestern State, this dynamic is a two-way street. Junk-rated **Chicago** and related issuers like **Chicago Board of Education** weigh on Illinois and the market's perception of the state, the trader said. Chicago is considered the state's economic engine, but both it and its school system face weighty financial challenges.

Illinois passed funding bills for schools without a full FY16 financial plan, but eviscerated higher education institutions and many human services as an ideological battle between Democrats and Republicans permeates the Prairie State.

The toxic political environment and lack of budget in Illinois and Pennsylvania creates uncertainty for local governments, said Martin Ives, a public finance expert and former deputy comptroller of New York City. This makes it difficult for local municipal managers and corporate leaders to plan ahead. Such was the case with **Peoria County**, Illinois--home to one of the country's biggest manufacturing giants, Caterpillar, Inc.

Pennsylvania has released some funding for schools without a formal budget, but charter schools and mainstream districts throughout the state remain precariously stressed after having to borrow money for months and dig into reserves to stay open. Some have threated to close in the coming months, as reported.

"They're both a microcosm of the United States," said Baxter of Pennsylvania and Illinois, referring to the political gridlock at the national level between the President and the Republican-controlled legislature.