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Connecticut Bond-Market Penalty Evaporates with Finances on Mend

State's yields holding closest to AAA benchmark since 2015

With finances mending, 'the market has rewarded them for it'

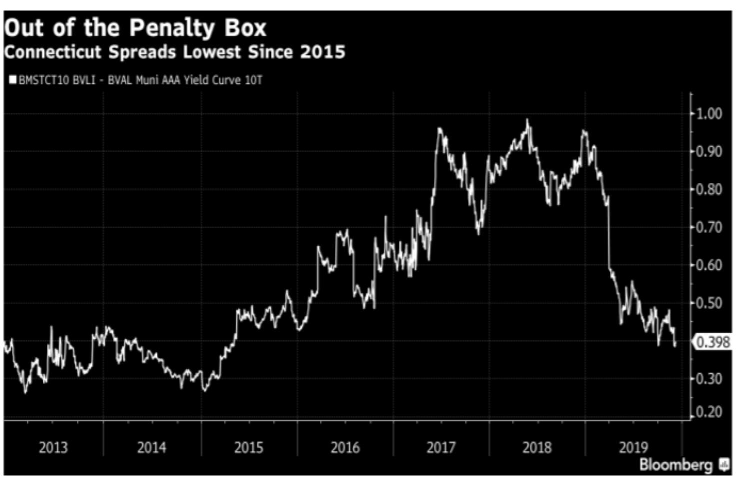
By Martin Z. Braun 12/11/2019 Bloomberg News

(Bloomberg) The bond market has stopped penalizing Connecticut.

The gap between its debt yields and the AAA benchmark has narrowed this year by more than any of the other 19 big states tracked by Bloomberg's indexes. That's left the yields on its 10-year bonds -- now about 1.9% -- hovering around 40 basis points above top-rated securities, the lowest since 2015 and less than half the premium investors demanded at the start of the year.

The drop marks a major shift for the wealthy state, whose slow recovery from the recession left it dealing with budget shortfalls long after other governments were reaping the bounty of the now record-long economic expansion. It has been driven by the stabilization of the government's finances, in part because of Wall Street bonuses, and strong demand for tax-exempt debt from Connecticut residents who were stung by the cap on state and local deductions and are using their investments to drive down what they owe.

"Connecticut has gone from trading like a triple B to an A rated bond that's consistent with our internal view," said Guy Davidson, chief investment officer of municipal investments at Alliance Bernstein. "They're a better credit than they had been in previous years and the market has rewarded them for it."



Connecticut, which is selling about $900 million of bonds Thursday, is projecting a deficit of just $31.6 million and has socked away $2.5 billion in reserve to cushion an economic downturn. It plans to add another $320 million by the end of the fiscal year.

Rewarding Finances

Last week, the state settled a legal dispute with hospitals that could have exposed it to $4 billion in liabilities. S&P Global Ratings assigns an A rating to Connecticut's general-obligation bonds, while Moody's Investors Service and Fitch Ratings rank them one level higher at A1 and A+, respectively.

Connecticut has labored under the weight of rising costs for debt, employee healthcare and underfunded pensions while its economy has stagnated since the Great Recession. The state's teachers' and state employee pensions are at least $38 billion short of what they need to pay projected benefits. Fixed costs eat up more than 30% of state spending.

But the government is being rewarded by Wall Street for taking steps to stabilize its finances. Unlike Illinois and New Jersey, Connecticut now pays the full required annual contribution to its pensions. The state also extended to 30 years its time frame to repay its retirement-fund debt, resulting in lower and steady annual payments even if it increases the overall cost.

In 2017, the state, which depends on Wall Street profits and bonuses for income-tax revenue, required the government to stock its rainy-day fund with any capital gains and bonus taxes that exceed a certain threshold. The legislature's fiscal arm projects the state's budget reserve fund will reach $3 billion, its statutory maximum of 15% of spending, in the fiscal year ending June 30, 2021. After reaching the cap, surpluses could be deposited in the state's pensions.

"The pension problem has stabilized at a low funded ratio, but isn't getting worse," said Davidson.

Yet Connecticut's economy didn't grow at all in the decade through the second quarter of 2019, according to the U.S. Bureau of Economic Analysis. While the state is home to billionaire hedge fund managers like Ray Dalio and Steve Cohen, higher paid sectors like finance and manufacturing are shedding jobs and the state's population has declined by 22,000 since 2014.

Absent a stronger economy, Connecticut's bond spreads likely won't narrow much more, said Davidson.

"Most of the upside now is going to be income advantage, not further price appreciation due to the improvement in Connecticut's budget," he said.