Bloomberg

For Connecticut Bonds, Nation's Laggard, the Risks May Only Rise

By Martin Z. Braun

(Bloomberg) -- Connecticut's bonds fared worse than any other state in 2016 -- and this year may not be much better.

The state's securities lost 0.6 percent last year, compared to 0.25 percent gain for the broad market, according to Bloomberg Barclays Indexes, and the extra yield that investors demand to hold 10-year Connecticut bonds instead of top-rated debt rose to a record 0.73 percentage point by Nov. 30. Now 0.61 percentage point, it may widen as the depth of Connecticut's financial challenges become more evident, according to UBS Wealth Management Americas analysts.

"The state has been resting on its laurels for many years," said Thomas McLoughlin, head of municipal research in New York at the UBS unit, whose views don't represent those of the whole company. "The longer term trend suggests that Connecticut is going to lose its position as one of the more favored states or one of the states that municipal investors hold in high esteem."

Connecticut, by some measures the wealthiest state, is facing a $1.5 billion budget deficit in the next fiscal year as costs for pensions, debt and retiree health care grow faster than revenue. Officials have drained reserves and face the prospect of boosting education spending for poor children to comply with a court order.

Meanwhile, its economy is struggling. High-paying finance jobs declined 11 percent between 2007 and 2014, and General Electric Co.'s decision last year to relocate its corporate headquarters to Boston, lowering its tax bill, underscores the state's challenge.

Connecticut bonds, rated AA- by Standard & Poor's Global Ratings, are trading like A rated debt, according to data compiled by Bloomberg.

Debt payments, pensions and retiree health care benefits will consume almost one-third of Connecticut's general fund revenue in fiscal 2018, limiting the state's ability to adjust its budget, according to S&P. Government employee pension liabilities exceeded assets by $26.6 billion as of June 30, 2015, or about $7,400 per resident.

"They have not recognized, in the broad sense, just how big the problem may be and which significant changes may be needed to rectify the problem," said Neil Klein, a senior managing director at Carret Asset Management in New York, which oversees about $800 million of municipal bonds.

Klein, who isn't increasing his position of Connecticut State general-obligation bonds, expects "somewhat stable" credit spreads this year. Connecticut debt may remain attractive for state residents who can benefit from the state income tax exemption, but potentially not for out-of-state investors, he said.

Connecticut has to cut services, raise taxes, and address its pension liabilities, Klein said. A proposal by Governor Daniel Malloy to stretch out payments for the state employee pension and reduce the assumed investment return to 6.9 percent from 8 percent, "isn't enough," Klein said.

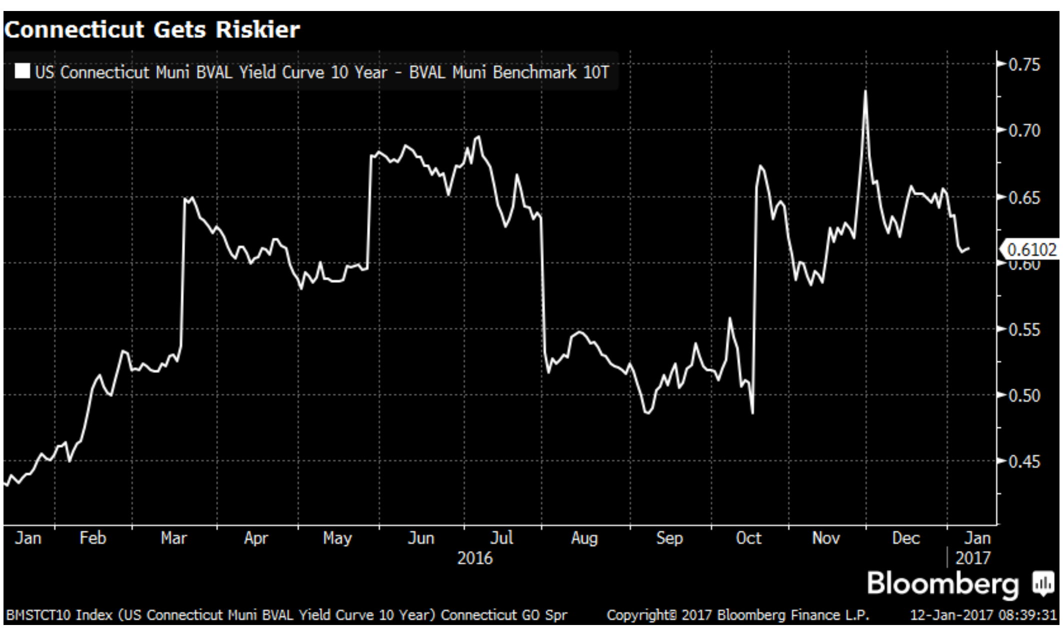
"The state may have more room to make changes than other municipalities," he said. "I don't necessarily believe that these changes will come easily."

In his annual state of the state speech on Jan 4, Malloy heralded an agreement with Sikorsky, a subsidiary of Lockheed Martin that will give the defense company as much as $220 million over 14 years to stay in Connecticut, boost full-time employment over 8,000 and increase spending with suppliers throughout the state by more than $300 million.

Pratt & Whitney, a United Technologies Corp. subsidiary, said it expects to hire 1,000 engineers in Connecticut this year and another 1,000 in manufacturing, according to the Hartford Courant newspaper.

Malloy said he will outline spending cuts when he presents his budget next month.

"We must recognize that a responsible and balanced solution to our budget problem is one that includes state employee concessions," Malloy said.



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