

As an active manager C.W. Henderson & Associates is conscious of credit deterioration and the credit spread widening that often ensues. We closely monitor all of our holdings and proactively look to sell credits we believe are weakening. The State of Connecticut (A1/A+) has made headlines recently as it struggled to enact a budget for the 2018-2019 biennium. Political gridlock, combined with numerous other credit headwinds, have led to multiple downgrades in recent years and leave the state in a precarious financial position going forward. State fiscal stress is also likely to trickle down to local governments and negatively impact their respective budgets.

Slow Economic Recovery:

Connecticut's economic recovery has lagged that of the nation, and the state has not yet recovered the jobs lost to the 2008-09 recession. Substantial revenue shortfalls, driven by weak income tax growth and underpinned by the lack of rebound in high wage jobs since the 2008-09 recession, have resulted in three consecutive operating deficits. Recent job growth has been concentrated in low-wage sectors such as retail and service jobs. There have also been several prominent corporate relocations out of the state in recent years, including both General Electric and Aetna. According to the U.S. census data, the state is only one of six to experience population decline since 2013.

Other Adverse Credit Features:

Despite a period of national economic growth, Connecticut's reserves have been nearly depleted and state officials have no plans to replenish them anytime soon. The state's fixed cost burden (debt service, pension, retiree healthcare) is one of the highest in the country, comprising nearly one-third of the budget. Pension costs have been and are expected to continue rising, and funded ratios for the state's employee and teachers' plans were 32% and 52%, respectively, as of June 30, 2016¹. Political gridlock has also plagued Connecticut recently, as the state legislature and governor only recently agreed upon and passed a budget for the 2018-19 biennium after a four-month impasse. Based on projections by the Connecticut Office of Fiscal Affairs, budget gaps resume in 2020. The chart below illustrates the trend of credit downgrades and credit spread widening that has occurred over the past six years.²

¹ FY2016 State of Connecticut CAFR

² Credit spread information provided by J.P. Morgan

Connecticut GO	Oct 2011	Oct 2014	Oct 2017
Moody's Underlying Rating	Aa2	Aa3	A1
S&P Underlying Rating	AA	AA	A+
Fitch Underlying Rating	AA	AA	A+
Spread over the 10-year AAA-rate Municipal Scale	+22	+29	+78

Effects on Local Credits:

Historically, Connecticut has provided significant funding to its local governments, largely in the form of education cost sharing (ECS) grants. The recently passed 2018-19 biennial budget includes a 5% funding reduction in ECS grants in fiscal-year 2018 followed by a modest increase in fiscal-year 2019. Looming budget gaps starting in fiscal-year 2020, however, raise the possibility of potential future cuts to local governments. While municipalities have the ability to increase local property taxes to help offset state revenue losses, any material rate increase could be politically difficult, as Connecticut already maintains the 5th highest property tax rate in the nation³.

During the budget negotiation process, Governor Malloy proposed a pension cost shift, which would alleviate some of the state's teacher pension costs by transferring part of the funding responsibilities to local governments. Although this proposal was not part of the legislation that ultimately passed, local governments will likely face the threat of this issue returning in the next few years.

Conclusion:

C.W. Henderson research analysts regularly perform thorough analyses of all our current and prospective holdings. We have not purchased Connecticut GO bonds since 2009 and currently maintain extremely selective exposure to the name. The research department's recommendation pre-empted any rating agency downgrades or spread widening. Our exposure to local municipalities has also been limited, and all current holdings mature in less than a year. As always, our research analysts are available to discuss Connecticut or any other credit issues.

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³ <https://www.usatoday.com/story/money/personalfinance/2017/04/16/comparing-average-property-taxes-all-50-states-and-dc/100314754/>