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Connecticut’s Deficit Shrinks and So Does its Bond Risk Premium

By Martin Z. Braun

• Connecticut 10-year bond spreads hit three-month low
• Surging stock market boosts capital gains tax revenue

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Connecticut’s deficit is shrinking and so is the risk premium on its bonds.

The state’s deficit has shrunk to less than $1 billion in the current fiscal year from an estimated $2.1 billion in mid August as surging U.S stock markets boost capital gains tax revenue and levies on partnerships. Like all states, Connecticut has also benefited from federal stimulus measures like enhanced unemployment benefits and small businesses loans.

The gap between the yield on Connecticut’s 10-year debt and the AAA benchmark has narrowed to about 0.4 percentage point, the lowest since early March, before states in the northeast shutdown to control the spread of the coronavirus. That premium has narrowed 0.7 percentage point since reaching a high of 1.1% in May, according to data compiled by Bloomberg.

Unlike New Jersey, which this week is borrowing $3.7 billion to plug its budget gap, Connecticut has salted away about $3 billion in reserves -- about 15% of general-fund spending -- after passing a law in 2017 that required the government to stock its rainy-day fund with capital gains taxes that exceed a certain threshold. The state deposited $530 million to the budget reserve at the close of the 2020 fiscal year on June 30.

“Since the stock market has gone gangbusters the last few years, it has allowed them to squirrel away money to put them actually in a pretty strong position to weather unexpected storms like a global pandemic,” said Matt Stephan, head of municipal bond research at Columbia Threadneedle Investments.

Home to the hedge fund industry and Wall Street bankers and traders, Connecticut depends heavily on finance industry profits and bonuses for income tax revenue. Federal stimulus, low interest rates and recent progress on a Covid vaccine has powered the S&P 500 index to about 12% gain this year, after plunging 33% between Feb. 20 and March 23. Wall Street investment bank revenue jumped 32% in the first half of 2020 as companies rushed to raise cash in the bond market to survive the pandemic, according to research firm Coalition.

While markets are riding high on optimism about a vaccine, sentiment can turn quickly. The seven-day average of new Covid-19 cases in the U.S. is climbing in every state, forcing officials to close businesses and schools. Connecticut, which was hit hard in the early days of the pandemic, is faring better than most other states, with a positivity rate of 5.4% over the last three days, Governor Ned Lamont said Monday. Governors in the region will be focusing on hospitalizations as a metric to guide response, he said.

“Unlike last time, we all agreed, that this time it’s not a matter of a lockdown, it’s not a matter of shutdown, it’s a matter of a tailored response,” Lamont said.

Stores should be able to remain open as long as patrons are masked and distanced, but gyms, religious congregations and indoor dining need to be monitored closely, Lamont said. Schools, especially at the lower grades, and workplaces haven’t been a source of spread.

Connecticut expects to collect $422 million more in estimated payments from wealthy taxpayers than forecast in April and $220 million more in revenue from tax on partnerships, according to projections released Nov. 10.

The state is also seeing an increase in real estate transfer taxes, which could in part be the result of a Covid exodus by some New York City residents. Connecticut’s real estate conveyance tax was revised higher by $50 million.

“We’ve seen a lot of people from New York City moving out to the suburbs, including Connecticut, because of the perception that it’s safer, less densely populated,” said Daniel Barton, co-manager of Mellon Investments Corp.’s Connecticut municipal bond fund. “Connecticut stands to really benefit from this outmigration.”