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PARSING PUERTO RICO

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KEY TAKEAWAYS

Puerto Rico's debt crisis remains isolated and not symptomatic of the broad municipal bond market.

Signs of contagion have not materialized and appear unlikely, although the probability of a default has increased.

Puerto Rico bond prices largely reflect a default and are trading close to anticipated recovery values.

Puerto Rico municipal bond prices continue to reflect a significant probability of a potential default or debt restructuring. Puerto Rican difficulties are coming to a head: The commonwealth is suffering through a recession that began in 2006, a severe cash crunch has increased the prospects of a missed bond payment, and a greater than forecast budget deficit means that revenue fell short again and more cost reductions are needed. The Puerto Rican government made notable progress in recent years to reduce its structural budget deficit, but a persistent recession has failed to drive revenue gains to help pay debt obligations.

In late June 2015, Governor Alejandro Padilla stated Puerto Rico's debt is "not payable" and "shared sacrifice" is needed by bondholders, raising the probability of a potential default. The statement may have been politically motivated or meant to influence potential negotiations with creditors, but nonetheless, the apparent lack of willingness to pay caught investors' attention. Puerto Rico has been unable to access financial markets due to its financial troubles, and therefore, unable to get needed funding to service debt and other expenses as revenue continues to decline.

Despite the news and latest rhetoric, Puerto Rico municipal bond prices already largely reflect a default. Prices range from the mid-$40s to low $70s ($100 is par), depending on the specific issuer and legal covenants or priority of payment backing specific bond obligations. Such deeply discounted prices reflect a significant probability that par value may not be recouped. Puerto Rico Electric Power Authority (PREPA) bonds have traded in the $40–50 range for several months as discussions about a possible debt restructuring have lingered during this period.

NO CONTAGION

So far, the broader municipal bond market has taken the Puerto Rico news in stride. Puerto Rico's debt problems are far from new; concerns began to escalate back in 2013, as a potential ratings downgrade into "junk" status loomed. Furthermore, Puerto Rico's debt problem is not comparable with any U.S. state. The average debt per capita is 15 times greater than that of the average U.S. state, according to Moody's data, and still 3 times greater than the worst state, Connecticut. Annual debt service consumes 25% of Puerto Rico's revenue

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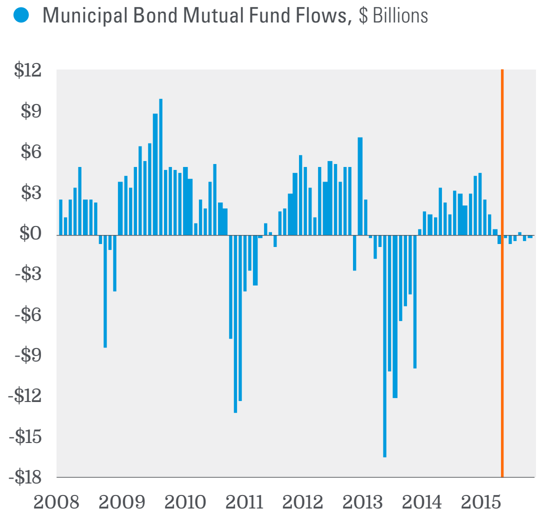
compared with just 5% for the average U.S. state. Puerto Rico's debt problem has been years in the making, and its inability to escape recession only meant that more serious debt servicing issues were likely just a matter of time. Finally, the broader municipal bond market outperformed the domestic taxable bond market in June 2015,* despite continued negative Puerto Rico headlines [Figure 1].

Mutual fund outflows, a key gauge of fear contagion, remain under control. Sustained mutual fund redemptions can exert significant pressure on the municipal bond market because roughly 70% of the market is owned by individual investors. In 2010, mutual fund outflows in response to state credit quality fears led to a prolonged period of weakness. Heavy outflows were evident in 2008 and 2013 as well and negatively influenced the broad market. Outflows have been limited in recent weeks, however, and not indicative of heavy selling [Figure 2]. In our view, this brief period of outflows was likely due to broad bond market weakness

2 MUNICIPAL BOND MUTUAL FUND OUTFLOWS HAVE BEEN LIMITED

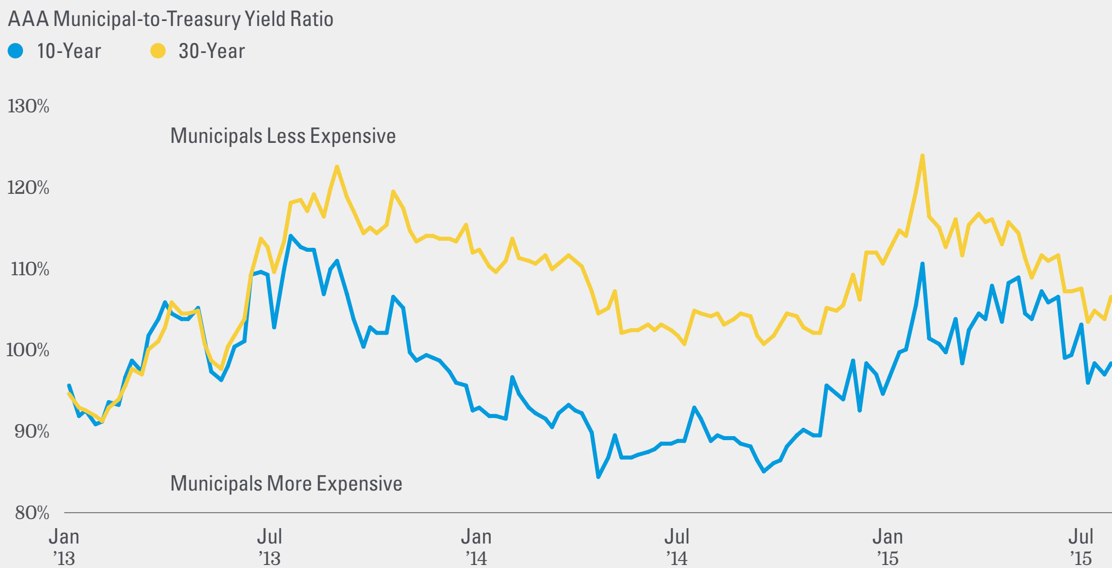


Source: LPL Research, ICI data 07/16/15

Monthly data through May 2015; weekly thereafter, denoted by vertical line

*Via comparison of Barclays Municipal Bond Index (-0.1%) versus Barclays Aggregate Bond Index (-1.1%).

1 MUNICIPAL BOND VALUATIONS HAVE RICHENED IN RECENT WEEKS DESPITE PUERTO RICO NEWS



Source: LPL Research, Municipal Market Advisors (MMA) 07/20/15

from mid-April through the end of June as investors sold for fear of rising interest rates, rather than fears related to Puerto Rico.

PUERTO RICO IS NOT GREECE

Several characteristics differentiate Puerto Rico from Greece. First, Puerto Rico's debt totals roughly $70 billion compared with a much larger $390 billion for Greece. Second, Puerto Rican banks are insured by the FDIC, which greatly limits the potential for bank runs or related stresses that are currently occurring in Greece. Third, as a U.S. commonwealth, Puerto Rico is eligible for fiscal assistance, although Congress is unlikely to authorize it. A potential bill to give Puerto Rico access to chapter 9 municipal bankruptcy is unlikely to gain traction, leaving Puerto Rico to restructure [see sidebar] or default.

POTENTIAL COMPLICATIONS

Governor Padilla's recent comments (and those of other government officials) suggesting "core services" may be paid ahead of bondholders, despite the constitutional pledge that general obligation bonds must be paid ahead of all other expenses, indicates a more complicated path may unfold. If Puerto Rico's government pursues its own payment priorities, rather than its constitutional or legal contractual obligations (similar to the situation in Detroit), bondholders may sue and a long court battle may follow. Under such a scenario, bondholders would likely not receive any payment until a court settlement is reached, a process that may take one or two years. Holders of insured bonds, however, would continue to receive interest payments as long as the insurer remains financially sound. Alternatively, a potential resolution may be further delayed if some bondholders reject any restructuring proposal.

Either of these outcomes may put additional downward pressure on select Puerto Rican municipal bonds due to the increased uncertainty and possible delay in finding a resolution.

DEBT RESTRUCTURING

In a debt restructuring, a bond issuer negotiates with bondholders for a potential settlement outside of bankruptcy court. As a hypothetical example of a debt restructuring agreement, bondholders may receive 70 cents on the dollar in compensation in the form of new bonds, likely with longer maturities and lower interest rates. In this way, the issuer makes the debt burden more feasible; however, such actions are still considered a default by rating agencies, as investors suffer a loss of capital in being forced to accept less than par value.

WHAT'S NEXT

Three Puerto Rican bond issuers are scheduled to make interest payments on August 1, 2015. A missed payment may comprise an actual default. On September 1, 2015, a forbearance agreement between bond insurers and PREPA is set to expire, and a debt restructuring (specific to that issue) may be proposed around that time. Beyond that, Puerto Rico is expected to run out of cash before September 30, 2015, indicating that a broader default may ensue unless the government is able to find a willing lender before then.

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CONCLUSION

Impact to the broader municipal bond market has been limited as most investors realize that Puerto Rico, like other troubled municipal bond issuers, remains an isolated case and is not symptomatic of the broad municipal bond market. Signs of contagion have not materialized and appear unlikely at this stage, although the probability of a default has increased. Puerto Rico bond prices largely reflect a default and are trading close to anticipated recovery values. Whether a final resolution results in a higher or lower price is uncertain and may remain so for a long time, depending on how debt talks unfold and the willingness of Puerto Rican government to honor debt service. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Investing in foreign fixed income securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with foreign market settlement. Investing in emerging markets may accentuate these risks.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

INDEX DESCRIPTIONS

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Barclays U.S. Municipal Bond Index covers the USD-denominated, long-term, tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

DEFINITIONS

Moody's Inc. is an independent, unaffiliated research company that rates fixed income securities. Moody's assigns ratings on the basis of risk and the borrower's ability to make interest payments. Moody's backs its rating with exhaustive financial research and unbiased commentary and analysis.

Credit quality, also referred to as a "bond rating," is one of the principal criteria for judging the investment quality of a fixed income security. Credit quality informs investors of a security's creditworthiness or risk of default.

Different agencies employ different rating scales for credit quality. Standard & Poor's (S&P) and Fitch both use scales from AAA (highest) through AA, A, BBB, BB, B, CCC, CC, C, to D (lowest). Moody's uses a scale from Aaa (highest) through Aa, A, Baa, Ba, B, Caa, Ca, to C (lowest).

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