Municipal Market Comments

Ascent Investment Partners

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Muni Market Takes Puerto Rico Junk Downgrade in Stride... For Now

On February 4, S&P lowered its rating on the Commonwealth of Puerto Rico to BB+ from BBB-. Moody's followed suit with its own downgrade on Feb. 8, to Ba2 from Baa3, dropping one of the municipal market's largest and most widely held issuers to junk ratings. S&P maintained an outlook of CreditWatch-Negative on its Puerto Rico rating, suggesting that the rating agency could downgrade Puerto Rico further in the next 90 to 180 days. Moody's outlook on the Commonwealth is also negative.

Since our last discussion of the credit fundamentals of the Commonwealth (the October 8, 2013 edition of Municipal Market Comments), there have not been any material changes in the macro credit picture. S&P's and Moody's downgrades were triggered by concerns over Puerto Rico's liquidity and access to capital markets at manageable interest rates, given the Commonwealth's need to fund deficits in 2014 and 2015 and to refinance existing near-term maturities into longer-term debt to manage cash flows. The downgrades themselves, however, trigger credit events for the Commonwealth that could create a liquidity crisis in the near term.

By lowering Puerto Rico's ratings below investment-grade, S&P's and Moody's actions trigger provisions in a variety of variable-rate debt issues and swap contracts that could require Puerto Rico's government to post collateral or redeem bonds in the very near term totaling approximately $940 million – almost 10% of the annual budget. Puerto Rico will undoubtedly negotiate with bondholders and financial counterparties to attempt to arrange some sort of forbearance or payment adjustment. The Commonwealth also plans to tap capital markets in the coming weeks. Its ability to do so successfully will be one key to averting a financial crisis.

Puerto Rico raises concerns for municipal investors not only for the potential for direct impacts on those holding Puerto Rico bonds or funds and ETFs invested in Puerto Rico, but also because of its large presence in the marketplace – Puerto Rico has approximately $16 billion of general obligation debt and $55 billion of agency debt of various types, so changes in the market for Commonwealth bonds has ripple effects for the market as a whole.

To date, we have not seen any significant changes in trading levels for Puerto Rico bonds or in the municipal market as a whole. We believe this is due to a number of factors, including:

- Puerto Rico's debt has been trading at deeply distressed levels since fall of 2013. The market has already discounted bond prices to reflect below investment-grade credit quality.
- Until Feb. 8, Puerto Rico still maintained two investment-grade ratings. As a result, institutions with rating limitations on their holdings have generally not had to liquidate their positions.
- Over the past two weeks, the markets have seen an extremely large shift in assets out of equity funds and into bond funds due to the gyrations in world equity markets. While very little of this fund flow has moved into municipal bond funds, the fact that short-term government bond funds and high-grade corporate bonds have been in high demand has also helped support general price levels in municipals (which generally tend to trade in relationship to Treasuries).

These factors are beginning to change, however, and we believe that there could be increasing negative pressure on muni fund prices and municipal market indices stemming from Puerto Rico's credit deterioration. While S&P's downgrade seemed to be digested by the municipal marketplace, new pressure from the Moody's downgrade risks starting cascading liquidity events. Puerto Rico's second downgrade to junk will, we expect, generate more active selling in the market, which could put downward pressure on municipals generally. Likewise, a reversal of fund flows away from bonds could raise pressure on municipal funds and ETFs if they are forced to fund redemptions.

Puerto Rico may have an impact on market levels in the near-term, but we continue to believe that the municipal market offers a high quality, tax advantaged way to generate income. Through careful credit selection, investors can avoid holding bonds from issuers with credit problems like Puerto Rico. Though the overall market may demonstrate weakness over the short-term, the long-term investor with a carefully structured portfolio can take advantage of temporary increases in rates to reinvest principal and interest payments at higher yields while still maintaining high credit quality.

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