Municipal Market Comments

ASCENT Investment Partners

September 10, 2012

from Montage Investments

Commonwealth of Puerto Rico Credit Update

Negative Outlooks Highlight Downside Credit Concerns

Commonwealth of Puerto Rico	Ratings	Outlooks
General Obligation bonds(1)	Baa1/BBB/BBB+	negative/negative/stable
Appropriation bonds (2)	Baa2/BBB-/BBB	negative/negative/stable

Sources: FitchRatings; Moody's; S&P

(1) Includes Commonwealth G.O. bonds and Puerto Rico Public Building Authority bonds guaranteed by the Commonwealth.

(2) Includes bonds secured by Commonwealth appropriations and issued through the Industrial Tourism Educational Medical & Environmental Control Facilities Authority and the Public Finance Corp.

The Commonwealth of Puerto Rico remains a popular holding for many municipal investors. Interest on Puerto Rico bonds is exempt not only from federal income taxes, but also from state and local income taxes in all 50 states. Due to tax exemption and the fact that Puerto Rico and its agencies are frequent issuers that have a large amount of debt outstanding, Puerto Rico bonds are held in many individual investment accounts and in large amounts in virtually all municipal mutual funds and ETFs. Even state specific funds tend to hold sizeable positions in Puerto Rico bonds due to the universal tax-exemption and the fact that they are usually much more readily available than tax-exempt bonds in many of the "specialty states."

Though it is widely held, Puerto Rico is rated lower than any of the 50 states and lower than most municipalities in the U.S. Furthermore, the Commonwealth faces significant financial challenges that are pressuring the credit downward. We view Puerto Rico as a declining credit that is in danger of having its appropriation debt downgraded to below investment-grade in the next one to three years. Such a downgrade could significantly impact the trading values and marketability of Puerto Rico bonds. Consequently, we do not view Puerto Rico bonds as suitable for conservative investors.

All three rating agencies have identified the next two years as a "make or break" period for Puerto Rico. We view the situation as very high risk, given that Puerto Rico must institute substantial reforms in government and pension funding and grow the economy in order to just maintain current rating levels. The government has depended largely on borrowing over the past 10 years to balance budgets and cover up structural weaknesses in general government and the operations of Commonwealth public corporations. Puerto Rico has become heavily dependent on the low rates in today's bond markets, and when interest rates begin to rise we expect many Puerto Rico issuers, including the Commonwealth itself, could have a very difficult time sustaining their current debt structures.

The main credit characteristics supporting Puerto Rico's current ratings and our outlook include:

- **Strong economic and political ties to the U.S.** Puerto Rico benefits from its political relationship with the U.S. and generates the majority of GNP from trade with the U.S.
- **Like states, Puerto Rico has broad sovereign powers to raise revenues and adjust expenditures.** The current government has taken significant steps to grow revenues and control expenditures, including reducing government employment by nearly 20% over the past three fiscal years.
- **Very weak economic performance.** Puerto Rico's economy has been in recession since 2006, though GNP is projected to grow by just under 1% in 2012.
- **Low wealth levels and high unemployment.** Puerto Rico has significantly lower wealth and income levels than the U.S. and much higher poverty rates. The island also has a persistently high unemployment rate. Puerto Rico has historically had difficulty generating private sector business and employment growth, driving the Commonwealth government to increase public sector employment. The recent public sector labor reductions have driven the island's unemployment rate above 15%, with little prospect of reducing that figure in the intermediate term.
- **Poor financial performance that has generated substantial deficits.** The Commonwealth has had large budget deficits in recent years that have forced substantial deficit borrowing. Though the current administration has eliminated the projected FY2013 budget gap, in large part by reducing government payrolls and implementing strict expenditure controls, budget pressures will remain high until there is sustained economic growth.
- **Very high debt levels.** Puerto Rico's public debt grew by more than 40% over the past three years due to borrowing to close massive budget shortfalls. The Commonwealth has debt metrics that are currently much higher than any U.S. state. Puerto Rico's tax-supported debt levels are more than eight times the U.S. state median on a per capita basis, and more than 22 times as high when measured as a percentage of GNP. Puerto Rico also provides financial support or credit support to a variety of other public issuers that further increases the potential debt burden.
- **A pension system facing a funding crisis.** Puerto Rico's public pension system is currently funded at only 6.8% of future benefit obligations. By comparison, the lowest funded state, Illinois, was recently downgraded by S&P to 'A' in part because its state pension systems are funded at only 43%. The latest actuarial study of Puerto Rico's pension fund projects that all assets will be depleted by 2019 or 2020. The government has announced plans to reform the funding of the system, but this will require substantial increases in payments into the system by employers already facing a tough economic environment.

Brian Tournier
Director of Research
Ascent Investment Partners

Disclosure: This newsletter is limited to the dissemination of general information pertaining to Ascent Investment Partners, LLC's ("Ascent Investment Partners") investment advisory services and general economic market conditions. The information contained herein should not be construed as personalized investment advice, and should not be considered as a solicitation to buy or sell any security or engage in a particular investment strategy. There is no guarantee that the views and opinions expressed in this newsletter will come to pass.

Ascent Investment Partners is an SEC registered investment adviser with its principal place of business in the State of Missouri. Ascent Investment Partners and its representatives are in compliance with the current registration and notice filing requirements imposed upon registered investment advisers by those states in which such registration or notice filing is required. Ascent Investment Partners may only transact business in those states in which it is noticed filed, or qualifies for an exemption or exclusion from notice filing requirements. Any subsequent, direct communication by Ascent Investment Partners with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of Ascent Investment Partners, please contact Ascent Investment Partners or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov). For additional information about Ascent Investment Partners, including fees and services, send for our Disclosure Brochure using the contact information herein.