# Municipal Market Comments

Ascent Investment Partners

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from Montage Investments

## Commonwealth of Puerto Rico Credit Update: Despite Positive Steps, Credit Trend Remains Negative

### Commonwealth of Puerto Rico

| | Ratings | Outlooks |
|---|---|---|
| General Obligation bonds[1] | Baa3/BBB-/BBB- | negative/negative/negative |
| Appropriation bonds[2] | Ba1/BBB- | negative/negative |

[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.

Sources: FitchRatings; Moody's; S&P

Puerto Rico continues to face significant challenges in stabilizing its credit ratings. Although the administration of Governor Padilla (elected in November 2012) and the legislature have taken significant steps to address some of the Commonwealth's underlying budget problems, many fundamental problems remain. We believe that Puerto Rico continues to be a deteriorating credit that is at high risk of being downgraded to below-investment-grade. Although there are a range of Puerto Rico issuers of varying credit ratings, we do not view any Puerto Rico bonds as suitable for conservative fixed-income investors.

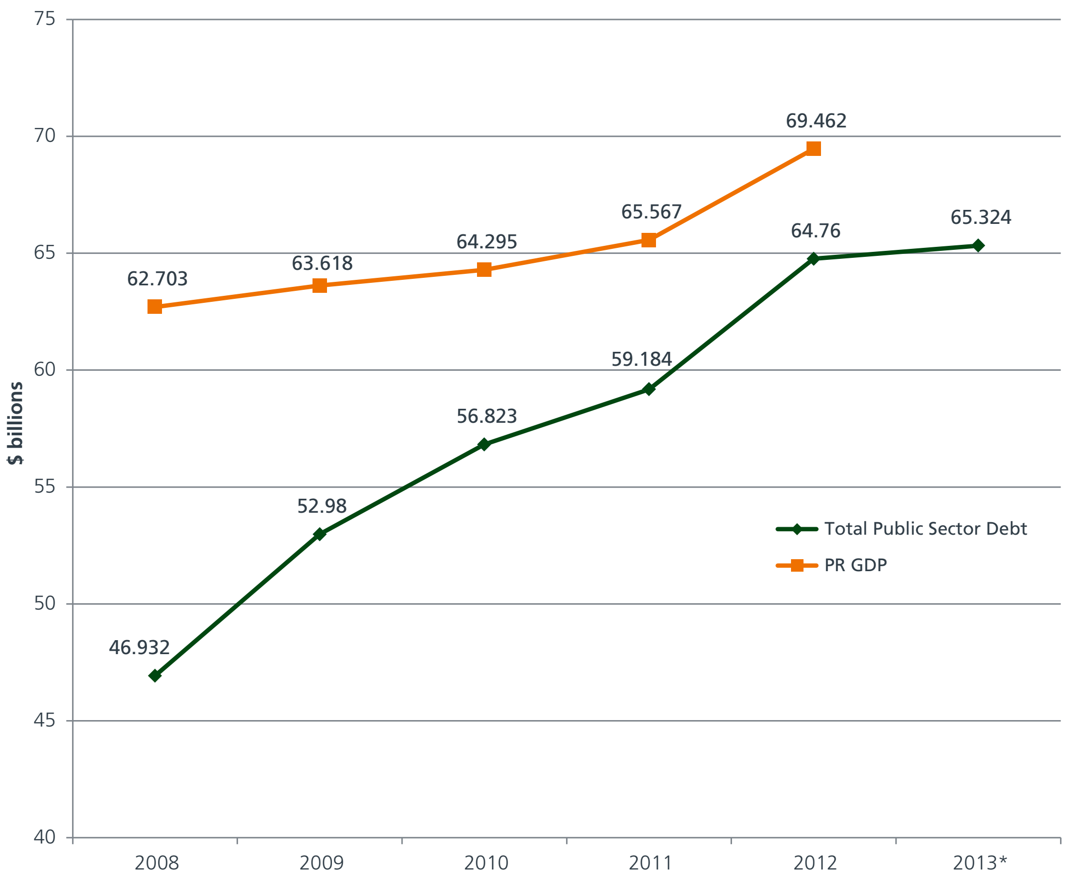
The Commonwealth of Puerto Rico remains a significant holding for many municipal investors, whether in individual accounts or in municipal ETFs and mutual funds, almost all of which hold Puerto Rico bonds. Interest on Puerto Rico bonds is exempt not only from federal income taxes, but also from state and local income taxes in all 50 states, making it a popular issuer for state-specific fund managers who face a limited supply of in-state tax-exempt bonds.

Since our last published review of Puerto Rico credit quality in September 2012, Puerto Rico's general obligation (G.O.) bond ratings have been downgraded from Baa1/BBB/BBB+ to the current level, one notch above junk by all three rating agencies. We noted last year that Puerto Rico was entering a "make or break" period in which it would either stabilize its budget structure for the long term or decline below investment-grade, a move which would likely lead to debt restructuring at the expense of bondholders. Despite the government's attempt to remake the Commonwealth's financial structure, there has not yet been enough positive movement to lead us to believe that Puerto Rico is headed in the right direction. Furthermore, the price volatility shown by Puerto Rico bonds over the past three months makes them inappropriately risky for most individual investors.

In recent days, there has been some discussion in the business press of the federal government's concern over Puerto Rico's financial position and the potential market effects of a Puerto Rico default. This has led some to speculate that the federal government might provide some sort of assistance to the Commonwealth to help support its credit. We do not believe that direct federal support for Puerto Rico bonds is likely. If there is some action on the part of the U.S. government that enhances Puerto Rico's credit position and boosts market values, we would view higher market prices as an opportunity to sell Puerto Rico holdings.

**Puerto Rico Total Public Sector Debt* vs. GDP**

**(2008 to 2012, $ billions)**



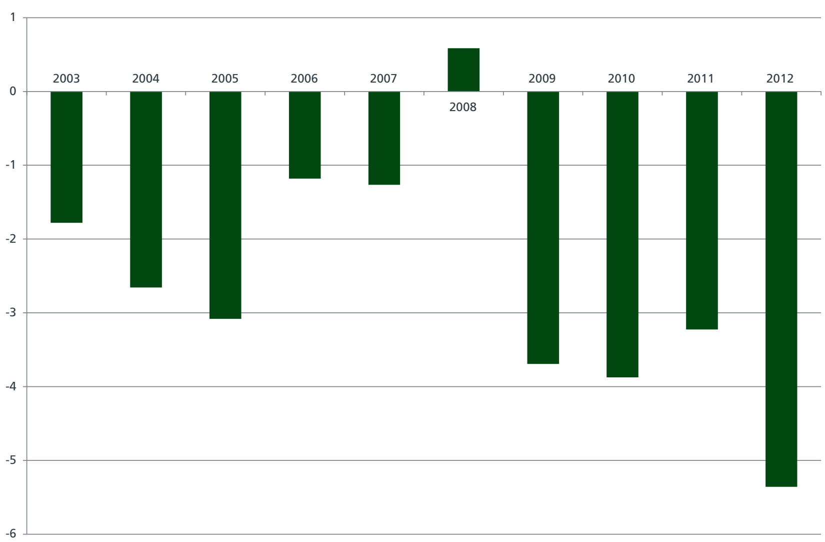

* Debt figures do not include $5.1 billion pension obligation bonds payable by the ERS.
Sources: Puerto Rico Government Development Bank; Ascent Investment Partners

The pressures driving down Puerto Rico's credit ratings include:

- An economy that has been in recession since 2006, although total fiscal year 2013 GDP may show very slim growth;
- Economic activity contracted sharply in June and July 2013, reversing the trend of growth that had emerged in 2012;
- 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 (13.5% as of July 2013);
- Puerto Rico has recorded multi-billion dollar net losses (on a government-wide basis) in nine of the past 10 fiscal years, with 2008's modest net positive number only coming as a result of $3.7 billion of non-recurring federal grants and contributions;
- The Commonwealth has resorted to debt financing to plug budget holes, resulting in a rapid debt growth since 2008;
- Puerto Rico now has a total public debt load of more than $70 billion, which is more than 100% of Commonwealth GDP and approximately $14,000 per capita (10 times the median debt-per-cap of the 50 states);
- Puerto Rico's high debt burden and reliance on capital market access for refinancing of long-term debt and short-term notes makes it very susceptible to financial shocks from rising rates and potential limitations on access to capital due to its declining credit quality; and
- The Commonwealth's three pension funds are extremely underfunded, with an aggregate unfunded liability of more than $36 billion. The largest and weakest fund, the Employees' Retirement System, was only 4.5% funded at fiscal year-end 2012 and was projected to become cash flow negative by 2015.

**Puerto Rico Annual Net Deficit**

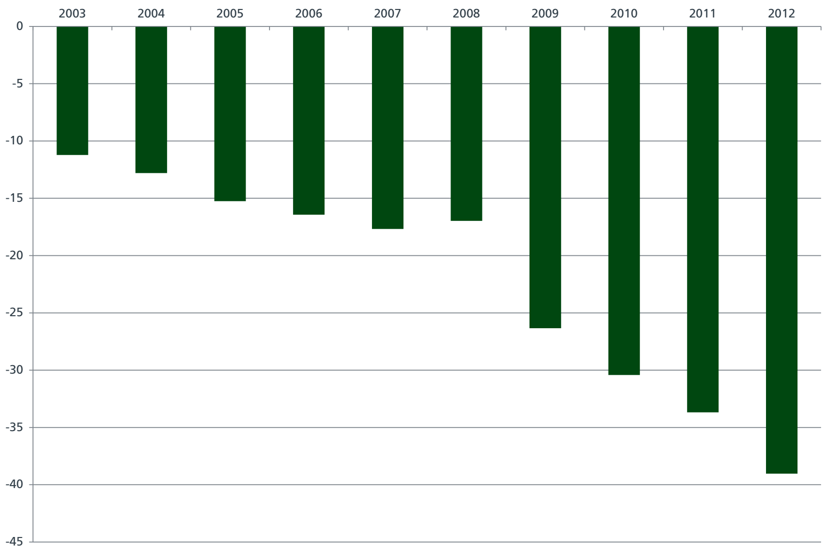
**(Total Primary Government, $ billions)**




Sources: Commonwealth of Puerto Rico; Ascent Investment Partners

**Puerto Rico Accumulated Net Deficit**

**(Total Primary Government, $ billions)**




Sources: Commonwealth of Puerto Rico; Ascent Investment Partners

The factors supporting Puerto Rico's current investment-grade ratings 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 its GNP coming from trade with the U.S.;
- Like states, Puerto Rico has broad sovereign powers to raise revenues and adjust expenditures;
- The current administration has shown commitment to enacting tax increases and other long-term changes designed to create a more stable budget foundation for the Commonwealth; and
- Puerto Rico has enacted pension funding changes that could make significant positive progress in arresting the funding decline in its three pension funds.

Puerto Rico's recent budget management has been typified by: borrowing to close budget gaps, refunding and restructuring outstanding bonds to take current-year savings and push out payments, and pushing obligations from the general government onto public corporations. As interest rates rise and Puerto Rico has more difficulty accessing low-cost capital, the Commonwealth will face an increasing potential for a financial crisis if it cannot roll short-term borrowings or refund, restructure and extend existing debt. Puerto Rico's credit will only stabilize when the island can grow GDP at a greater rate than the growth of debt and public spending.

Currently, Puerto Rico projects that recently increased taxes and fees, combined with substantially improved collection and enforcement programs, will generate strong revenue growth in FY2014 and beyond, helping to close budget gaps and stabilize the Commonwealth's credit. While initial signs have been encouraging, the recent slowdown in economic activity is a warning sign that collections through the rest of FY2014 may fail to meet projections.

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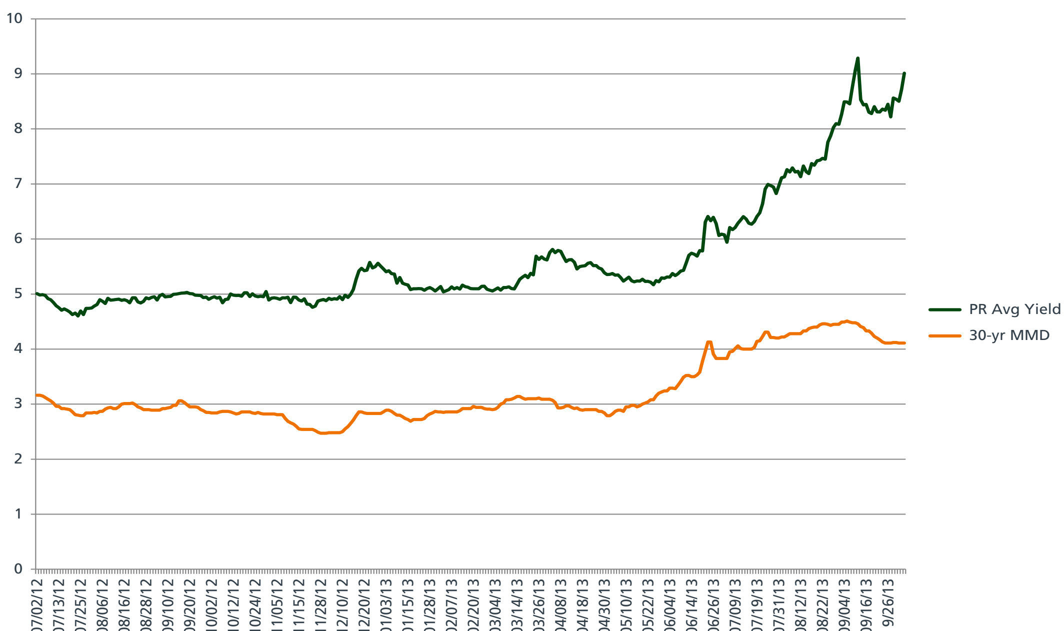
The Commonwealth's current revenue growth projections are dependent on tax increases having no net negative impact on economic activity on the island. To the extent that higher sales taxes, excise taxes, payroll taxes and other measures reduce economic activity or force more of the island's economy "off the books," the projected impact of the tax increase could fall far short of projections. Puerto Rico has a long history of revenues failing to meet estimates and expenditures growing more than expected. Until the Commonwealth can show the ability to establish realistic budgets and stick to them, we are doubtful it will meet its current financial projections.

Trading values for Puerto Rico bonds have been hit hard since the Detroit bankruptcy filing in early June. Long maturity Puerto Rico debt has been hardest hit, with G.O. bonds that were issued at par in early 2012 recently trading at prices below $60. With yields now above 8%, a number of non-traditional buyers, including international institutions, hedge funds and distressed debt buyers are currently buying Puerto Rico bonds. As a result, Puerto Rico has become much more of a headline-driven name that we expect will continue to show high volatility and liquidity only for larger blocks of bonds. We do not view Puerto Rico as an attractive yield opportunity for conservative investors in such a market, as we continue to believe there is more downside risk than upside potential in the Commonwealth's bonds.

**Puerto Rico G.O. vs. High-Grade Municipal Yields**

**(PR 5.0% due 7/1/2041)**




Note: Pricing data is for CUSIP 74514lb89 as of Oct. 4, 2013. Yields shown are the MSRB-reported daily average yield for trades of this bond. High-grade municipal yields are the MMD Aaa 30-year general obligation bond yield.
Sources: Thompson Reuters; Bloomberg; Ascent Investment Partners

**Brian Tournier**
Director of Research
Ascent Investment Partners

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