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Puerto Rico Default Risk Defied With Rally: Muni Credit.

A potential restructuring of junk-rated Puerto Rico power bonds has failed to end the best rally in two years for the riskiest part of the $3.7 trillion municipal market.

With benchmark interest rates on city and state obligations close to the lowest in a generation, munis rated below investment grade are getting a boost from a 50 percent drop in issuance and the debt's additional yield compared with corporate securities.

The shortage of high-yield bonds is overshadowing Puerto Rico's move last month to allow some public corporations to cut their debt load by negotiating with investors. The junk-rated U.S. territory and its agencies have $73 billion of debt, giving them outsize influence on high-yield munis. The self-governing island of 3.6 million is the municipal market's third-largest debtor, behind California and New York.

"There's so little high-yield supply," said Daniel Solender, who helps oversee $15.5 billion of munis at Jersey City, New Jersey-based Lord Abbett & Co. "And the yields compared to other markets are still attractive too, so all of that could support it going forward."

Power Candidate

The Puerto Rico Electric Power Authority, which supplies most of the island's electricity, is the leading candidate to ask bondholders to take a loss under the new law, passed June 28. With $8.6 billion of debt, it would be the largest muni restructuring ever, surpassing the $8 billion of general obligations and water and sewer debt in Detroit's historic bankruptcy filing. The Motor City has continued to pay its water and sewer debt, although the securities are considered distressed because of the bankruptcy.

Governor Alejandro Garcia Padilla, who took office in January 2013, proposed the debt-restructuring bill June 25, igniting losses in Puerto Rico and high-yield local-government debt. Munis rated below investment grade lost 1.7 percent in the week ending July 4, the worst performance in a year, according to S&P Dow Jones Indices.

Since then, the securities have rebounded, for an 8.5 percent advance in 2014 through July 21, the most since 2012, and beating the 6.2 percent gain in the broader market. Puerto Rico bonds, which are tax-exempt nationwide, have recovered to levels from before June 25.

Prepa Rebound

Uninsured Prepa bonds maturing in July 2026 traded yesterday at an average price of 46.74 cents on the dollar, the highest since June 24, data compiled by Bloomberg show. The debt traded as low as 36.68 cents July 2. Yesterday's 14.95 percent yield was equivalent to a taxable rate of 24.75 percent for top earners.

High-yield securities are those rated below Baa3 by Moody's Investors Service and lower than BBB- by Standard & Poor's and Fitch Ratings.

Investors such as hedge funds and nontraditional buyers of munis took advantage of the cheapening in Puerto Rico, said Mark Paris, who helps manage the $6.8 billion Invesco High Yield Municipal Fund (ACTHX) in New York. The third-largest U.S. mutual fund focused on that segment of munis will close to new investors Aug. 1 because of the debt shortage.

Puerto Rico officials want to reduce the island's debt load as the commonwealth's economy struggles to grow. An index that tracks Puerto Rico's economic activity has contracted 18 percent since 2005, according to the Government Development Bank, which handles the island's debt sales. While the 13.1 percent jobless rate is the lowest in almost six years, it's more than double the U.S. average.

Broader Impact

The fallout from Puerto Rico's new debt law is also generating opportunities for traditional muni buyers, by increasing yields on some investment-grade and junk-rated munis beyond the commonwealth's shores, said John Miller, co-head of fixed income in Chicago at Nuveen Asset Management, which oversees $92 billion of munis.

Tobacco bonds, transportation debt, health-care securities and land-backed bonds have cheapened since Puerto Rico lawmakers passed the bill, Miller said.

The municipal market is set to shrink in 2014 for the fourth consecutive year. States and cities have scheduled $6.6 billion of sales in the next 30 days, 21 percent below the three-year average, Bloomberg data show.

Sales of junk-rated debt have dropped to $990 million this year, from $2.1 billion in the same period of 2013. This year's tally doesn't include Puerto Rico's $3.5 billion March general-obligation deal because it was targeted at hedge funds and other buyers of distressed debt.

Supply Driver

"People realize that there's good opportunities still in the muni market," Paris said. "There's still not going to be a lot of supply this year."

Investors have slowed their exodus from high-yield muni funds, yanking $59.5 million last week, after an outflow of $691 million the prior week, the most in a year, Lipper US Fund Flows data show.

Munis are also benefiting from gains in Treasuries and investors' familiarity with the risks of owning Puerto Rico, Paris and Solender said. Yields on 30-year Treasuries set a 13-month-low this week.

"This is really about Puerto Rico," Paris said. "A lot of people have already shied away from Puerto Rico, whether it be mutual funds or individual investors. This doesn't have to be a big contagion to the rest of the muni market."

Yields on junk-rated munis exceed those on speculative-grade corporate securities. The opposite is typically the case, Miller said. Junk munis maturing in about seven years yield 7.39 percent, or two percentage points more than comparably rated company debt, according to Barclays Plc data.

That relative value will help lower-rated munis, Miller said.

"That ratio is really very high and munis would typically yield less than high-yield corporates," Miller said. "The tax advantage for our customer base is typically really strong too."

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Jul 22, 2014 5:00 PM PT

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