

# **Bond Case Briefs**

*Municipal Finance Law Since 1971*

---

## **Puerto Rico at Precipice Piles on Muni Market Hampered by Crises.**

Illinois and New Jersey have dragged down the municipal-bond market this year as the states wrestled with growing pension-fund bills. Puerto Rico is depressing it even more.

Even before Puerto Rico Governor Alejandro Garcia Padilla said this week that the junk-rated island can't afford to pay its debts, municipal bonds had returned about nothing in 2015 as investors dumped securities of the cash-strapped states and the Federal Reserve moved toward raising interest rates for the first time in nine years.

The pressure on the \$3.6 trillion market is building as Puerto Rico seeks to restructure its \$72 billion debt load, raising the specter of a record-setting default. With about half of municipal mutual funds holding Puerto Rico bonds, that may fuel selling by investors who've been pulling money from the market for the past two months.

"There seems to be a confluence of events," said Vikram Rai, head of muni strategy in New York at Citigroup Inc.

"Puerto Rico is a one-off case, but it's a debt restructuring which is coming at the wrong time," he said. "That's what worries me — that it could end up impacting everything."

### **Pulling Funds**

The municipal market is dominated by individual investors, who moved money elsewhere after the recession amid speculation that defaults would rise and in 2013, when Detroit filed for bankruptcy. Another exodus has been building: They had already taken \$1.9 billion from muni mutual funds for the past eight straight weeks, the longest stretch in 18 months, Lipper US Fund Flows data show.

The price of Puerto Rico's most frequently traded securities tumbled this week, hitting record lows, after Garcia Padilla said the teetering island can't afford to make good on all of its debts. He said officials want to negotiate with investors to postpone debt payments and will propose a restructuring plan by the end of August.

Commonwealth securities pared their losses Wednesday after the Puerto Rico Electric Power Authority avoided defaulting on a \$415 million bond payment and reached an agreement to continue negotiations with creditors out of court.

### **Greek Buffer**

There was no immediate fallout in the broader municipal market from Puerto Rico's push to restructure its debts, with yields little changed this week as investors snapped up the safest assets amid Greece's escalating debt crisis.

"We have this other macro factor that's out there called Greece," said Chris Alwine, head of munis at

Vanguard Group Inc., which oversees \$145 billion of the debt. “Most of the municipal market is high quality, and it’s rallying based on the Greek news that’s out there.”

Puerto Rico had already exerted a drag on the muni market, with its securities losing 2.3 percent before Garcia Padilla’s announcement, S&P Dow Jones data show. The index ended the first half down 9.4 percent.

Struggling states also contributed to the market’s non-existent returns. During the first half of the year, Illinois debt dropped 0.9 percent, while New Jersey obligations plunged 1.1 percent, the steepest losses of the 27 states tracked by S&P.

Both have been unable to keep up with escalating retirement bills. In New Jersey, Governor Chris Christie rolled back a promised pension payment to close a budget shortfall, which may increase the cost in later years. The Illinois Supreme Court struck down lawmakers’ solution for a \$111 billion pension deficit in May, dealing a setback to the state’s plan to steady its finances.

## **Pension Contagion**

That ruling also caused Moody’s Investors Service to cut Chicago to junk in May, saying the city has fewer options for shoring up its own underfunded retirement system.

Matt Posner, a managing director at Concord, Massachusetts-based Municipal Market Analytics, said the downgrade led investors to demand higher yields on debt from other borrowers with pension-fund deficits. On May 14, two days after Chicago lost its investment-grade rating, some New Jersey bonds traded for yields of 1.7 percentage points more than benchmark munis, the most since at least 2013 and up from a 2015 average of 1.2 percentage points until then.

“I’ve never seen the contagion or knock-on effect on seemingly unrelated credits like I did directly as a result of the Chicago downgrade,” Posner said. “Investors are penalizing other credits when there’s the perception of a pension issue.”

The weakness in the municipal market will probably persist because of Puerto Rico’s actions, Michael Zexas, chief municipal strategist at Morgan Stanley, wrote in a report Tuesday. The worst-case would be if a debt restructuring by the commonwealth coincides with rising interest rates and deteriorating credit quality among large borrowers like Illinois and Chicago, Zexas wrote.

Like Puerto Rico, shortchanging pensions has been “a slow-moving train wreck,” Vanguard’s Alwine said. “A problem that was always more intermediate-term has become near-term.”

Bloomberg

by Brian Chappatta

June 30, 2015 — 9:01 PM PDT Updated on July 1, 2015 — 8:47 AM PDT