

Bond Case Briefs

Municipal Finance Law Since 1971

Puerto Rico Fallout Seen Contained as Muni Defaults Prove Rare.

The good news for investors in the \$3.6 trillion municipal market: only one bond issuer rated by Moody's Investors Service defaulted during the past two years, the first time that's happened since the late 1990s.

The bad news: Puerto Rico is almost certain to miss payments on some of its \$72 billion of debt, which may leave investors recovering as little as 35 cents on the dollar, the New York-based credit rater said.

The stability beyond Puerto Rico helps explain why there's been few market ripples as the island careens toward a potentially record-setting default. Munis are poised for their biggest monthly returns since January, according to Bank of America Merrill Lynch data, as investors shrug off the long-building crisis brought about by the commonwealth's unique financial strains.

"Munis went through a lot of stress in the Great Recession and a lot of them did really hard work to rebalance," said Al Medioli, a Moody's analyst who worked on the annual default report the company released Friday. "This is still a very stable, high-quality sector."

States and cities that raise money in the municipal market have been steadily mending from the worst recession since the 1930s, which forced them to cut spending when tax collections tumbled. Speculation about widespread defaults, which caused investors to flee the market in 2011, were proven off base, even as a few cities, including Detroit, stumbled into bankruptcy.

Market Rarity

Defaults by borrowers rated by Moody's are rare, according to its study. Just 95 did so from 1970 to 2014. Only eight of those were general-obligation bonds, which are backed by a government's pledge to use its taxing power to repay investors.

Last year, not one of the approximately 15,400 munis that Moody's rates missed a payment, the first year without such a lapse since 1997.

This month, Dowling College in Oakdale, New York, became the first in 2015 that Moody's deemed in default. The school had seen enrollment plunge 53 percent over the past four years.

The drop in defaults may be short lived. Some localities will be forced to renege on their obligations in the years ahead as retirement costs swell and the long U.S. recovery left "more governments with less margin and weaker positions from which to weather another sharp recession," Moody's said.

"The absence of defaults in 2014 is not really a harbinger of good times; we expect defaults to occur in years to come," it said. "We see no sign that the forces pressuring the public sector have abated."

Junk Cities

The share of junk-rated local governments doubled since 2011 to 0.6 percent by the end of last year, Moody's said. Atlantic City, New Jersey, Chicago and Wayne County, Michigan, are among those with speculative grades.

Puerto Rico is also on the list. Last month, Governor Alejandro Garcia Padilla said the island can't afford to repay all that it owes as the economy struggles and residents leave for the U.S. mainland. Its Public Finance Corp. may miss an Aug. 1 debt payment because the legislature didn't appropriate funds.

The median rating for an issuer the year before it defaults is Ba3, Moody's said. Puerto Rico's general-obligation bonds, its highest-rated securities, are ranked Caa3, six steps below that.

The chances of the commonwealth defaulting "is approaching 100 percent," Moody's said in a report Wednesday.

Guessing Game

What sort of losses that would spell has been a matter of speculation. Moody's estimates that buyers of securities with weaker protections may get as little as 35 cents on the dollar. The recovery rate on others, such as general-obligation debt and senior sales-tax bonds, may be as much as 80 percent.

Medioli, the Moody's analyst, said such a default won't come as a shock. Puerto Rico bonds have plunged 9 percent this year, compared with a 0.5 percent gain for munis as a whole, S&P Dow Jones Indices data show.

"People were watching Puerto Rico all of last year" to see if it would miss a payment, he said. "They keep pulling rabbits out of a hat. They're able to do something to defer what increasingly seems like an inevitable situation."

Bloomberg

by Brian Chappatta

July 23, 2015 — 9:01 PM PDT Updated on July 24, 2015 — 6:05 AM PDT