Commentary

February 7, 2014

SEI New ways. New answers.®

Puerto Rico Credit Downgrade: Now Where to?

By: Sean Simko and SEI Fixed Income Portfolio Management

Follow Sean Simko on Twitter @SEISeanS

Whether investors are conducting credit due diligence or reacting to market news, it is important to note that most deteriorations in fiscal health and market sentiment do not happen quickly in the municipal space. Looking at the lack of reaction from the overall municipal market place in response to the credit downgrades in Puerto Rico underscores this point. The almost total lack of movement in the Municipal Market Data scale seems to indicate that the downgrades were largely priced into the marketplace, and that the eventual move to speculative grade was inevitable.

Just a short week after Standard & Poor's placed the Commonwealth and its associated credits on credit watch, the rating agency made its movement official by lowering the Commonwealth's general obligation credit and associated entities to speculative grade. Following suit, Moody's Investor Service adjusted their ratings of Puerto Rico and its entities to speculative grade as well. These changes in both outlook and ratings come after a complicated year for Puerto Rico, which saw its government try to plug the leaking ship. However, as we have seen since the start of the great recession, the sort of deep fiscal cuts needed to correct years of imbalances are never quick in coming—and, even when they arrive, are sometimes ineffective. In recent months, Puerto Rico has fast tracked pension reform initiatives and rolled out ways to boost revenues and create new economic development. Whether these efforts will help the Commonwealth recover in the long term has yet to be seen. Either way, the outcome is mostly a non issue for the rating agencies, which seem to be more concerned with the Commonwealth's current liquidity situation and ability to access the capital markets.

The lingering question around Puerto Rico debt for municipal investors is, "how will this affect my portfolio?" Investors in SEI's Low Turnover municipal strategies should be aware that we have been avoiding this credit for almost three years and have no exposure to the Commonwealth or its affiliated credits.

One of the largest concerns touted by media pundits has been that a downgrade for Puerto Rico would lead to immediate forced selling on behalf of municipal funds. Most funds have large exposure to the Commonwealth due to its unique triple tax-exempt status. An interesting and largely unknown fact is that many of these funds have provisions that allow them to hold bonds that have been downgraded to junk (to avoid forced selling), and some even have split rating provisions so that only one of the three rating agencies needs to rate the debt as "investment grade." Also supporting our thesis is the lack of negative movement, and even positive price movement, on monoline issuer stock prices. For example, Puerto Rico bonds insured by Assured Guaranty are almost $6.5 billion in notional value. Since the announcement of the downgrade by Standard & Poor's, the price of Assured Guaranty Stock is up by almost 3%—not too shabby for an insurer that could be looking at a heavy claims payment. The attitude of the equity markets seems to be that this will be a non event for the company.

Puerto Rico is far from being out of the woods from a fiscal standpoint. Despite its best efforts to adopt a balanced budget almost a year early, the Commonwealth's liquidity is still being called into question and will likely be punished by the capital markets. Two of the largest concerns from a liquidity standpoint are that the last rating agency will follow suit, forcing the Commonwealth to post collateral on its almost $9 billion swap portfolio, and that Puerto Rico will be looking at a substantial yield penalty as it tries to come to market with a $2 billion debt issuance. The Commonwealth held off on making a deal in the fall of 2013 because it was concerned about the high rates of borrowing and that the market needed more time to digest the positive moves it had made—a move that should prove costly for future bond issuance.

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice. This information is for educational purposes only.

There is no guarantee that the Fund's income will be exempt from federal or state income taxes or the federal alternative minimum tax. Capital gains, if any, are subject to capital gains tax. Bonds and bond funds will decrease in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments.

There are risks involved with investing, including loss of principal. No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities.

SEI Investments Management Corporation or its employees may sometimes hold positions in the securities discussed here.

SEI Fixed Income Portfolio Management is a unit of SEI Investments Management Corporation, which serves as the investment advisor.

SEI Fixed Income Portfolio Management manages fixed-income strategies for SEI's Managed Account Program (MAP).