

The SPECTRUM GROUP

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Special Report on Puerto Rico Bonds ⁽¹⁾

VULTURES IN PARADISE

A million shades of green, atop shimmering blue waves breaking into white foam, overlooked by mountains tall, beneath a baleful sun and gossamer clouds; such is the setting of paradise. And such is Puerto Rico, a gleaming isle of gorgeous land located between the Caribbean Sea and the Atlantic Ocean.

Paradisiacal as it is, it certainly is not trouble free; decades of socialistic thought and action have made government the chief driver of virtually all activity be it economic, fiscal, social, health, educational and cultural among others. Years of dancing to said big government music have made the dancers queasy, the musicians weary and consequently few outsiders are looking to how buy tickets to enter the sorry spectacle of an unappetizing party. Some however are looking.

Vultures and other carrion feeding creatures perform valuable functions to society and so do vulture investors. These, heeding J. Paul Getty's famous pithy comment: "Calamity is Opportunity" and so, several "smart" investors have begun to nibble at Puerto Rico assets

CPG, reputedly Real Estate experts, being supposedly backed by Goldman Sachs, have been buying distressed bank loans assets steadily; Putlam Bridge Group has made a purchase of a high-end marina property on the eastern shore as well as a center-city residential development. John Paulson, who after looking at Puerto Rico as a tax-advantaged personal residence, took over 80% of a 5 star St. Regis and resort property in Rio Grande, putting in big cash, OC-ZIFF and Lone Star also. Speculative purchases no doubt, but ones firmly anchored on attractive spots and counting that the world's economy will not crash and that the eternal lure of sun, sand, sea and fun will entice increased tourism, more residents and an economic resurgence.

1 Normally, yet irregularly, we comment on US securities and our sample stock portfolio, this issue does not. However, although we expect temporary market hits until the shutdown is terminated our positive outlook on US stocks markets persists.

Another wave of "smart" vultures are also circling ... "Bond Speculators". Bonds used to be traditional places for the less than brilliant well-to-do to park savings and their own offspring in a steady, safe and dull market. No more, with the post Carter interest rate volatilities, a new and exciting space was born, especially when low cost leverage became available to a world awash in cash, thereby incentivizing bond speculation.

The Municipal Finance divisions of brokerage firms around the world posted the "spread" between bond yields and cost of borrowing on a daily basis, thereby guiding their traders into riskless arbitrage. However this expanded into speculative temptation as interest rates fell and arbitrage-spread-profits grew.

Earlier this year the bell sounded, signaling the end of rate lowering and perhaps a reversal. The consequent forced deleveraging does not happen cleanly, it is a messy and often costly business. Nowhere is it more messy and costly than in Puerto Rico, whose easy arbitrage profits and yields lured retail investors in to illiquid funds whose fall and attendant margins calls are forcing massive selling of underlying bonds and other holdings.

The 17% drop in Puerto Rico Muni Bond prices is the current level, which may not include the full COFINA downgrade nor the posted negative outlooks. However the "blood in the street" is not yet prevalent. Said hemorrhage is more likely to come if and when a definite downgrade to junk status occurs. We are not venturing a prediction, but we are conscious of the underlying concern over Puerto Rico's credit worthiness which is its weakening economy.

So far, the "chief driving government" alluded to earlier, has not shown signs of fully understanding the problem nor effectively working on solutions. Therefore, whether junk status comes or not, things will probably not improve significantly through December 2013 when either "junking" will occur or be perceived as a certainty and the liquidity crisis may worsen. That will be the time for the Vultures and even regular investor to pounce.

Said "pouncing" on Puerto Rico Bonds may have slowly begun. We have been visited by several hedge funds of varying sizes and philosophies, most of them wondering whether Puerto Rico assets can be a good investment. Past performance being no comfort to these enlightened investors and the immediate future being perceived as gloomy; with liquidity concerns, professional class emigrating, government weak, preoccupied with social issues and "uncreative" stop-gap measures the only apparent remedies; the vultures hover, nibble, but have yet to pounce.

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The reason for hovering instead of pouncing has to do with the fear that the "bonds get paid-first-feature" of the Puerto Rico constitution could be changed, ignored or somehow bypassed, leaving the pouncing vultures with poisoned carrion. Spectrum augurs that such a venomous default will not happen, and poses 7 reasons for our conviction:

1. Puerto Rico is a territory, not a state nor a sovereign country; therefore it cannot file for bankruptcy.
2. We are under the direct responsibility of the US Congress, a fact usually ignored by both it and local government, but a fact which nixes direct federal intervention.
3. Puerto Rico bonds are the biggest, most widely held and important element in the entire large US Municipal Market. A default on these would create havoc in Municipal Finance, denying all states, counties, cities, even the credit-worthy municipal entities access to financing at reasonable rates.
4. Whether "too big to fail" or not, such a failure would certainly be caused by an alteration of the Puerto Rico Constitution which is a constraining fear expressed by professional investors, but it should not be a real fear. Said Constitution was reviewed, revised and amended by Congress to read as it does, when approved and still today. Therefore any attempt to remand it would have to count on Congressional overview. Congress, being aware of the massive implications to the nation's financial system would have to act, perhaps even appointing a trustee as it did to Washington, DC some time ago.
5. Regardless of uncertainty and dilly dally displayed by the Administration, they are trying and may even be achieving some success. A minute increase in manufacturing employment is being felt, and further increases from the also modest, but real US manufacturing expansion from the China reversal. So hope cannot be abandoned.
6. Beyond all of the above, stands the fact that Puerto Ricans are a proud and so inherently conscious of their own culture that even after 115 years of American colonial dominance, language, customs and unique personality persist. As a rule, we pay debts and meet obligations, probably slowly and late, but in whole. Another plus is that we will have to go back to the well often, thereby we must be careful as to not see it closed to further borrowings. And so, the bonds may suffer from our sputtering economy and ride the vagaries of market happenstances, but they will be paid, eventually, but certainly and in full.

Therefore, to our friends and clients we urge patience, perseverance and wisdom. As we have been saying for over two years, do not buy Puerto Rico Bonds yet - wait for the winds of downgrade to gather force and come December or whenever the howling sounds of downgrade eclipse the facts - and prices fall under 50% then **BUY-BUY-BUY!!!**

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