Municipal Brief

Puerto Rico Credit & Market Update

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- S&P placed the Commonwealth's 'BBB-' GO and related credit ratings on CreditWatch with negative implications on 24 January 2014, following similar actions by Fitch and Moody's in November and December 2013, respectively. Sales tax debt issued by the Puerto Rico Sales Tax Financing Corporation was not affected by the rating action. S&P also revised the outlook on its 'BBB' rating of power revenue bonds issued by the Puerto Rico Electric Power Authority to negative from stable and placed its 'BBB-' rating on the University of Puerto Rico on CreditWatch. (See Fig. 1).

- S&P's decision to place the Puerto Rico GO rating on CreditWatch followed an announcement that it was considering a downgrade of the Government Development Bank's 'BBB-' issuer credit rating. S&P expressed concern over the bank's market access and liquidity. The rating agency expects to resolve the GDB CreditWatch in the next several weeks and anticipates up to a two-notch downgrade.

- GDB Interim President Pagán responded to the rating agency action by saying that the GDB and the Commonwealth are comfortable with current liquidity levels and have a variety of options for raising additional liquidity, including a planned return to the public debt markets in the near-term.

- Puerto Rico's fiscal team was scheduled to meet with S&P, Fitch and Moody's this week to discuss the Commonwealth's progress on the fiscal and economic front.

- The probability of a downgrade of the Commonwealth's GO and related bond ratings by all three rating agencies into the non-investment grade category by the end of the fiscal year (30 June 2014) is high. Given the myriad obstacles facing Puerto Rico, we believe that at least one rating agency will take such an action within the next 30 days.

Fig. 1: Select Puerto Rico credit ratings
As of 29 January 2014

	Moody's	S&P	Fitch
Puerto Rico GO bonds	Baa3 ratings under review	BBB- watch neg	BBB- RW neg
Puerto Rico Sales Tax Financing Corporation (COFINA) senior and subordinate lien revenue bonds	A2 (sr), A3 (sub) ratings under review	AA- (sr) A+ (sub) negative outlook	AA (sr) A+(sub)
Puerto Rico Electric Power Authority (PREPA) revenue bonds	Baa3 ratings under review	BBB negative outlook	BBB-
University of Puerto Rico (UPR) university system revenue bonds	Ba1 ratings under review	BBB- watch neg	NR
Government Development Bank for Puerto Rico (GDB)	Baa3 ratings under review	BBB- watch neg	NR

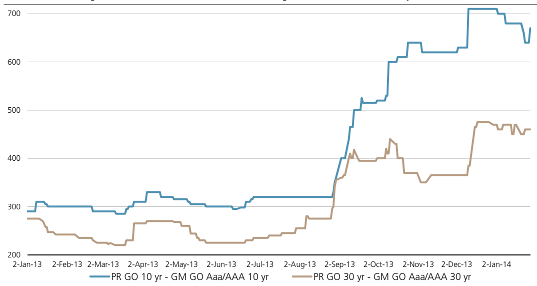
Source: Moody's, S&P, Fitch, UBS CIO WMR

Market update

The municipal bond market has performed well thus far in 2014. We believe that a variety of technical factors have contributed to the broad based market rally. The decline in US Treasury yields, low new issue volume, and positive mutual fund flows (particularly in the high yield segment) have been constructive for municipal bond prices. Tax loss selling, which was prevalent in December, also has abated.

Puerto Rico bonds have performed just as well, if not better, than the market as a whole in 2014. On a year-to-date basis, an index of Puerto Rico credits returned 2.45% while the broader municipal bond market is up 2.02%, according to Barclay's data. Since the publication of our last report (*Puerto Rico Credit and Market Update*, 10 January 2014), credit spreads at the 10-year spot had narrowed to +640bps over the AAA benchmark curve, from 680bps, before reversing course on 28 January and expanding by 30bps to stand at +670bps. At the 30-year point, spreads have fluctuated in the +450bps to +460bps range from +470bps earlier in the month. (See Fig. 2).

Fig. 2: Credit spreads for Puerto Rico GO Bonds
2 January 2013 - 28 January 2014, in bps



Source: MMD , UBS CIO WMR, as of 28 January 2014

In an unwelcome development, the Puerto Rico Supreme Court halted implementation of the teachers' pension system reform on 14 January as it considers a lawsuit seeking to overturn the law on constitutional grounds. The court appointed a special commissioner to collect evidence, hold a hearing and submit a report of findings by 7 February. While investors appeared to digest that news in stride, we feel that the additional concern posed by the threat of an imminent downgrade from S&P is likely to pose an impediment to further improvement in Puerto Rico bond valuations. More recent data suggests this to be the case. Prices have weakened in the wake of S&P's decision to place the Commonwealth credit on CreditWatch, which suggests that the market has still not fully "priced in" the impact of a downgrade.

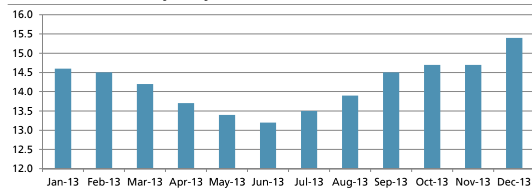
For example, an institutional sized block of COFINA bonds carrying a 5.25% coupon maturity in 2040 traded at a price of USD 80.362 (6.86% yield) on 28 January versus USD 81.077 (6.80% yield) on 23 January. Examining trades in other Puerto Rico names, prices on Puerto Rico Electric Power Authority (PREPA) bonds also declined. PREPA bonds with a 5.25% coupon due in 2033 traded at an average price of USD 63.898 (9.30% on 28 January) versus USD 64.438 (9.22% yield) on 22 January. Elsewhere, Commonwealth GO bonds carrying a 5.75% coupon maturing in 2038 traded at an average price of 72.125 (8.47% yield) versus USD 72.450 (8.43% yield) on 24 January.

Rating update

We previously had expressed a view that the probability of a downgrade of the Commonwealth's GO bond rating by at least two rating agencies into the non-investment grade category by the end of the fiscal year (30 June 2014) was high. Our attention was focused on Moody's and Fitch but we were obliged to note that recent events were likely to cause S&P to re-examine its assessment sooner rather than later. Heightened concerns about market access and liquidity provided such a trigger and led to last week's announcement from S&P.

The agency stated that it would "expect to resolve the CreditWatch on GDB in the next several weeks and anticipates up to a two-notch downgrade." S&P is now positioned alongside its two principal competitors to be able to downgrade the Commonwealth's GO and related debt into the non-investment grade category.[1] The credit ratings of the GDB and the Commonwealth are closely linked; hence, any downgrade of the Bank is likely to trigger a downgrade of the Commonwealth. S&P, which until now had been the most sanguine in its assessment of the Commonwealth's credit, appears poised to adopt a more critical credit evaluation.

Fig. 3: Puerto Rico unemployment rate
In %, seasonally adjusted



Source: Bureau of Labor Statistics, UBS CIO WMR, as of 23 January 2014

New data releases

The US Census Bureau released its latest population estimates on 23 January 2014. The data is used in federal funding allocations as well as other purposes and highlights some of the looming demographic challenges. As of 1 July 2013, the island's population was estimated at roughly 3.6 million, a net loss of 110,703 from the April 2010 census. The result reflects net outmigration over the three year period of 144,389 offset by an increase of 33,686 in "natural" population growth (births – deaths). In fiscal year 2013 (1 July 2012 to 30 June 2013), the total population loss was 36,459 based on net outmigration of 45,764 and natural population growth of 9,305.

Meanwhile, the Bureau of Labor Statistics (BLS) reports that Puerto Rico's unemployment rate inched up to 15.4% in December 2013. (See Fig. 3). Following five months of declines beginning in February 2013, the unemployment rate has increased steadily since July. The latest data now shows two of the eight industry sectors tracked by the Bureau as having gained jobs on a year-over-year basis, relative to only one previously. Leisure and hospitality continued to show growth and, as of December, is joined by the trade, transportation & utilities segment.

Legislative update

Recent legislative efforts have been centered on improving liquidity at the Government Development Bank. We discussed Senate Bill 857 in our *Puerto Rico Credit & Market Update* report published on 8 January. The bill, which would allow the GDB to withdraw up to USD 2.8bn of public funds held at private banks on the island, was sent to conference committee after the Senate refused to concur with House amendments.[2] The legislation places certain limits on GDB loans to the general fund and orders agencies to restructure debt with the GDB and negotiate repayment plans by 1 July 2016.[3]

Moody's declared the legislation to be "credit neutral for Puerto Rico's banks" in a sector comment published on 13 January 2014. The rating agency opined that the transfer of public deposits away from the private banking sector *would not* affect bank lending practices because the deposits are not used to fund loans and are largely collateralized by high quality securities. It also expects that actual deposit withdrawals would be "materially less" than the full USD 2.8bn because a large portion are in operating accounts used for cash management and other services which the GDB cannot currently accommodate.[4]

S&P took a slightly different stance. In its decision to place the GDB's credit rating on watch, it noted that "reduced deposits from public agencies and local municipalities" *could* hurt the local banking sector.[5] S&P also took action on the ratings assigned to several Puerto Rico-based banks on 24 January.

Two more recent legislative initiatives, House Bill 1591 and House Bill 1593, which relate to the sales tax, were signed into law by Governor Garcia on 24 January and go into effect on 1 February. As discussed in our prior reports, sales and use tax (SUT) collections have been lagging budgeted expectations and the Treasury Department has been working aggressively to increase collections.

HB 1591 increases the portion of the SUT dedicated to COFINA from 5.5% to 6% and reduces the amount benefiting Puerto Rico local governments from 1.5% to 1%. Once enough revenue has been set aside to pay annual debt service on COFINA bonds from the 6%, the GDB will transfer up to 0.5% of SUT income to the municipal administration fund on behalf of municipal governments. The fund would then distribute that money among the municipalities participating in the agreement. If insufficient SUT collections are available to make the 0.5% distribution, the Commonwealth is obligated to pay interest to the fund. For the period of 1 February to 30 June 2014, Treasury will deposit USD 43.4mn into the fund for distribution among the municipalities, the same amount distributed in the prior year.[6]

HB 1593 creates a subsidiary of the GDB called the Municipal Finance Corporation (or COFIM, by its Spanish acronym). The 1% municipal portion of the SUT will be directly deposited into this fund. COFIM is authorized to issue debt to refinance approximately USD 600mn of debt held by the island's 78 municipalities on the GDB's books.[7] Mayors can opt out of the new system and some have signaled they will do so.

End Notes

[1] Related ratings include those applying to the Puerto Rico Employees Retirement System, the Puerto Rico Infrastructure Financing Authority, the Puerto Rico Convention Center District Authority, Commonwealth-guaranteed debt issued by the Puerto Rico Aqueduct and Sewer Authority, and the Puerto Rico Highways and Transportation Authority. Separately, the rating agency placed its ratings of the Puerto Rico Industrial Development Company and the University of Puerto Rico on CreditWatch with negative implications and revised the rating outlook of the Puerto Rico Electric Power Authority from stable to negative.

[2] Source: *The San Juan Daily Star*, 24-26 January 2014

[3] Source: Municipal Market Advisors, *Weekly Outlook*, 27 January 2014

[4] Moody's, Sector Comment, "Withdrawal of Public-Sector Deposits is Credit Neutral for Puerto Rico's Banks", 13 January 2014

[5] S&P, "Various Rating Actions taken on six Puerto Rico-based Banks", 24 January 2014

[6] *El Nuevo Dia*, "Approved project restructuring municipal IVU', 23 January 2014 (translated)

[7] *The Bond Buyer*, "Puerto Rico approves city sales tax bond structure", 27 January 2014

Appendix

Statement of Risk

Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond's sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor's total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
GO	General Obligation Bond	TEY	Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)
MMD	Municipal Market Data		

	Rating Agencies			Credit Ratings
	S&P	Moody's	Fitch/IBCA	Definition
Investment Grade	AAA	Aaa	AAA	Issuers have exceptionally strong credit quality. AAA is the best credit quality.
	AA+	Aa1	AA+	Issuers have very strong credit quality.
	AA	Aa2	AA	
	AA-	Aa3	AA-	
	A+	A1	A+	Issuers have high credit quality.
	A	A2	A	
	A-	A3	A-	
	BBB+	Baa1	BBB+	Issuers have adequate credit quality. This is the lowest Investment Grade category.
	BBB	Baa2	BBB	
	BBB-	Baa3	BBB-	
Non-Investment Grade	BB+	Ba1	BB+	Issuers have weak credit quality. This is the highest Speculative Grade category.
	BB	Ba2	BB	
	BB-	Ba3	BB-	
	B+	B1	B+	Issuers have very weak credit quality.
	B	B2	B	
	B-	B3	B-	
	CCC+	Caa1	CCC+	Issuers have extremely weak credit quality.
	CCC	Caa2	CCC	
	CCC-	Caa3	CCC-	
	CC	Ca	CC+	Issuers have very high risk of default.
	C		CC	
			CC-	
	D	C	DDD	Obligor failed to make payment on one or more of its financial commitments. this is the lowest quality of the Speculative Grade category.

Appendix

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