Perspective on Puerto Rico's Debt Downgrade

February 6, 2014

The latest headlines report that Puerto Rico's troubles intensified recently. On February 4, Standard & Poor's Ratings Services reduced its rating on Puerto Rico's General Obligation debt to below investment grade amid concerns about liquidity, namely Puerto Rico's ability to access the capital markets to obtain financing as it reportedly seeks to prepare a sizable debt offering in the coming weeks. However, Rafael Costas, co-director of our Municipal Bond Department, doesn't find this ratings news particularly surprising, believing the anticipated downgrade had already been pretty well priced into the markets. He also notes that the progress Puerto Rico has made has gotten lost beneath all the headlines.

While the timing may have taken everyone a little off guard, S&P's decision to downgrade Puerto Rico's General Obligation debt to BB+ from BBB- and its decision to retain a negative outlook wasn't really a surprise to us. In our view, the market had already been largely discounting this news (as illustrated by trading levels for Puerto Rico's debt since the fall), so we didn't see an outsized market reaction immediately after the news broke. We note that ratings for the Puerto Rico Electric Power Authority (PREPA), Puerto Rico Aqueduct and Sewer Authority (PRASA) and the Sales Tax bonds ("COFINA" bonds) were not changed.

S&P reports that its action reflects its concerns about short-term liquidity, but the ratings agency said it expects Puerto Rico to be able to access the market in a few weeks to shore up liquidity.[1] If Puerto Rico's upcoming debt offering is deemed successful, we have reason to believe the "negative outlook" might be removed. We will have to wait and see what S&P's reaction will be if the financing is not deemed successful.

It is important to note that Puerto Rico's government has stated it has sufficient liquidity for the remainder of this fiscal year, which ends on June 30, 2014. [2] This includes meeting potential swap collateral postings and acceleration of maturities that can be triggered by the downgrade; the dollar value of these items is estimated by S&P at $800 million to $1 billion.[3] Additionally, Puerto Rico is reportedly negotiating with lenders to waive some of these provisions and establish new letters of credit.[4]

S&P also acknowledged the various actions Puerto Rico has taken in the last two years to reduce its structural budget deficits, noting that, due to better-than-projected revenues and lower expenses, the deficit for this current fiscal year is expected to be reduced from $820 million to $650 million.[5] Puerto Rico's governor also announced he will be submitting a balanced budget for fiscal year 2015, one year ahead of his initial timetable.[6]

As the situation looks to us today, downgrades by ratings agencies Moody's and Fitch are still possible and would not be surprising. That said, we still believe that Puerto Rico will pay principal and interest on its obligations on time and in full, and we have been encouraged by the numerous actions the current administration has taken so far to attempt to reduce the structural deficits and put Puerto Rico on a better fiscal path.

Now that its general obligation debt has been downgraded to below investment grade, it could take Puerto Rico a number of years to regain its investment-grade rating, and we do expect continued volatility in pricing over the next few months as announcements are made regarding the situation in Puerto Rico and digested by the investment community.

On the positive side for fixed income investors generally, US Treasuries have rallied recently amid concerns about emerging markets, which has helped bring some investors back into munis in January. The muni market has also benefitted from low supply at the start of the year. Additionally, we think the general improvement the US economy has been experiencing in the past year should help bring in more revenues for state and local governments.

Many investors gravitate toward munis for preferred tax treatment, as well as potential income. We expect that as tax season approaches this year, investors will look for ways to reduce their tax bill along with ways to achieve potential income, and munis can play a part. Tens of millions of baby boomers are on the verge of retirement, and we expect that many will be looking to increase their fixed income exposure. We believe that investing in municipal bonds generally remains compelling, despite some pockets of volatility.

Rafael Costas' comments, opinions and analyses are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

Get more perspectives from Franklin Templeton Investments delivered to your inbox. Subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

What Are the Risks?

All investments involve risks, including possible loss of principal. Municipal bonds are affected by interest rate movements. Municipal bond prices, and thus, a tax-free income fund's share price, generally move in the opposite direction of interest rates. As the prices of the municipal bonds in a fund portfolio adjust to a rise in interest rates, the fund's share price may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. Many Franklin tax-free income funds hold a portion of their assets in Puerto Rico municipal bonds that have been impacted by recent adverse economic and market changes. This along with adverse economic and regulatory changes in other U.S. territories may cause their share price to decline. These events may include economic or political policy changes, tax base erosion, constitutional limits on tax increases, budget deficits and other financial difficulties, and changes in the credit ratings assigned to the territory. For more detailed information about risk, please review a current Franklin tax-free income fund prospectus.

Revisions made to above risk language on April 9, 2014

1. Source: S&P Capital IQ. This may contain information obtained from third parties, including ratings from credit ratings agencies such as Standard & Poor's. Reproduction and distribution of third party content in any form is prohibited except with the prior written permission of the related third party. Third party content providers do not guarantee the accuracy, completeness, timeliness or availability of any information, including ratings, and are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, or for the results obtained from the use of such content. THIRD PARTY CONTENT PROVIDERS GIVE NO EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. THIRD PARTY CONTENT PROVIDERS SHALL NOT BE LIABLE FOR ANY DIRECT, INDIRECT, INCIDENTAL, EXEMPLARY, COMPENSATORY, PUNITIVE, SPECIAL OR CONSEQUENTIAL DAMAGES, COSTS, EXPENSES, LEGAL FEES, OR LOSSES (INCLUDING LOST INCOME OR PROFITS AND OPPORTUNITY COSTS OR LOSSES CAUSED BY NEGLIGENCE) IN CONNECTION WITH ANY USE OF THEIR CONTENT, INCLUDING RATINGS. Credit ratings are statements of opinions and are not statements of fact or recommendations to purchase, hold or sell products. They do not address the suitability of securities or the suitability of securities for investment purposes, and should not be relied on as investment advice.

2. Source: Government Development Bank for Puerto Rico and Commonwealth of Puerto Rico Treasury Department, Press Release, "Treasury Secretary and GDB Chairman Comment on Standard & Poor's Ratings Services Action" (February 4, 2014)

3. Source: See footnote 1.

4. Source: See footnote 2.

5. Source: See footnote 1.

6. Source: See footnote 2.

Posted in Fixed Income Tagged Franklin Templeton municipal bond funds, investing in municipal bonds, Puerto Rico Debt downgrade, puerto rico junk bonds, Rafael Costas, tax benefits of municipal bond investing, tax-advantaged mutual funds, tax-exempt bonds, tax-free income strategies

Important Legal Information

FINRA's BrokerCheck

You can check the background of your investment professional on FINRA's **BrokerCheck**.

Links can take you to third party sites/media, directly or through new browser windows. We urge you to review the privacy, security, terms of use, and other policies of each site you visit. You use any third-party site, software, and materials at your own risk. Franklin Templeton does not control, adopt, endorse or accept responsibility for content, tools, products, or services (including any software, links, advertising, opinions or comments) available on or through third party sites or software.

Franklin Templeton welcomes your feedback on this blog. To keep the conversation respectful and focused, please follow our current Commenting Guidelines. We review comments and reserve the right to block any comment or commenter, including those that we may deem inappropriate or offensive. We may block any comment or commenter whose posts include investment testimonials, advice, or recommendations, or advertisements for products or services, or other promotional content.

Questions or comments about your Franklin Templeton account or customer-service issues? Please contact us directly but never include account or personal financial information in your comments.

The comments, opinions and analyses are the personal views expressed by the investment manager and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice and it is not intended as a complete analysis of every material fact regarding any country, region, market or investment.

All investments involve risk, including possible loss of principal.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Franklin Templeton Distributors, Inc.