Talk From The Trenches: Puerto Rico Can't Be All Bad News

By Isobel Kennedy

NEW YORK, JAN 16(MNI) - Not a day goes by, it seems, that a piece of negative news does not hit the tapes on Puerto Rico, but amid all the gloom there are some bright spots.

The Global Interdependence Center, a Philadelphia-based nonprofit, hosted a very thorough panel discussion on the situation in Puerto Rico Wednesday covering everything from the economic situation to the market impact and the ratings outlook.

A common theme during the seminar, which was well attended by investors and sell-siders, was the uncertainty. No one really knows if Puerto Rico's debt will be downgraded to junk in the months ahead or if it will end up defaulting on those obligations. On the other hand, the country could continue its fiscal efforts, the economy could start to turn around and the bonds be paid off as promised.

Most important, the underlying mood seemed to be that the urgency of the situation has passed for the time being on both Wall Street and in Washington, D.C.

After all, yields on uninsured Puerto Rico general obligations with a coupon of 5.5% maturing in 2039 were as high as 10.30% late last year and they are currently trading around 9.35%. The bonds are on the last rung of investment grade but the prices already reflect an extremely high rate of risk. In May of last year before the markets fell out of bed this issue was trading at 5.25%.

At the height of illiquidity in the late summer and early fall, the hedge funds charged to the rescue and some probably made some handsome profits off the carnage.

The Street expects Puerto Rico to return to the market soon to prove that it has access, one of the requisites the rating agencies look at.

Participants at Wednesday's seminar suggested the territory might want to come to market with a taxable bond that would encourage pension funds and foreign investors to participate. Any issuance would probably come at a very nice discount to current levels in order to provide investors with a cushion for taking the risk.

No one is quite sure what is taking place behind closed doors in Congress, Treasury or perhaps the Federal Reserve. But most at the meeting believe the government is rightfully concerned and if things continue to deteriorate, Congress might be forced to at least consider action. No one had specific solutions to suggest, but resurrecting the concept of Brady bonds was one popular idea.

Only partially-tongue-in-cheek, a few suggested that if Russia, Venezuela or China offered to help Puerto Rico, Congress would jump into action pretty quickly.

They wondered how China, which holds $1.3 trillion in Treasuries, would view U.S. inaction when one of its own territories was in trouble. Would Congress turn its back on the Federal Housing Administration next?

In fairness, some felt the government was being quiet about the situation for fear of sparking a panic and worsening the situation. That makes sense. If the government is talking about aid things must be bad, right?

It also appears that the large Puerto Rico banks all have access to the Fed's discount window as members of the Second Federal Reserve District - which is overseen by the New York Fed.

It is widely known that the mutual fund community holds high levels of Puerto Rico debt in many state funds merely because PR debt is triple-tax exempt and is a perfect fit for most of these funds to pump up yields.

They sold some of those holdings when everyone was trying to squeak through the same key hole as rates were rising and fears of Federal Reserve tapering were rising. The timing of Detroit's bankruptcy filing did not help either.

But it did come to light at the Global Interdependence Center conference there is indeed a limit to how many junk-rated bonds a mutual fund can hold. But that limit only applies to new bonds that are purchased as junk not bonds that are downgraded to junk while they are in the funds. That is a very big plus that could limit forced selling in the event PR is downgraded again.

It was also noted yesterday that the highest concentration of Puerto Rico paper at any mutual fund is 16% but that those percentages drop rapidly and some big name funds only own about 5%.

Puerto Rico will continue to be monitored each day by everyone in the financial community and by people on Main Street as well. It is a very fluid situation and the headlines are likely to get worse before they get better.

Rocky months surely lie ahead, but Moody's says at the current rating of Baa3/rating under review it expects the Commonwealth to make their debt payments in full and on time.

As luck would have it, while the conference was taking place, a few pieces of bad news started circulating.

Reuters reported that the Puerto Rico Supreme Court halted the recently enacted reforms to the teachers pension plan as teachers staged a strike this week.

Pensions experts have noted that it is impossible to underestimate the importance of the reform that was just passed as it affects both existing and future beneficiaries. Raising taxes on water was equally difficult.

Also Wednesday, it was reported that the law firm of Jones Day would meet with bond holders and investors Thursday to review the outlook.

In response to news of this meeting, Puerto Rico Treasury Secretary Melba Acosta Febo and Government Development Bank Interim President Jose V. Pagan Beauchamp said Wednesday the island government will do everything possible to honor its obligations.

The following is the text of the statement that MNI ran late Wednesday afternoon.

"A recent news article commented on an upcoming meeting of Puerto Rico's creditors and included speculation about the Commonwealth's credit situation. We believe it is not unusual, as part of the normal investment process, for private investors to meet with advisors to discuss a range of issues, and we understand that meetings of this nature occur periodically. We did not call for, were not invited to and are not participating in this meeting. We made significant progress in implementing our fiscal and economic development plans in 2013, and are determined to continue that progress in 2014. As we have stated publicly in the past, Puerto Rico will take every step necessary to continue honoring its obligations."

Back in the Treasury market, the 10-year yield was back to 2.84% after hitting a high yield of 2.91% on Wednesday. But there was not much going on with people looking for the next big thing that will push prices one way or another.

Talk From the Trenches is a daily compendium of chatter from Treasury trading rooms, as well as some sister market trading rooms, and is offered as a gauge of the mood in the financial markets. It is not necessarily hard, verified news.

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