

# Puerto Rico misses payment, GO bonds selloff

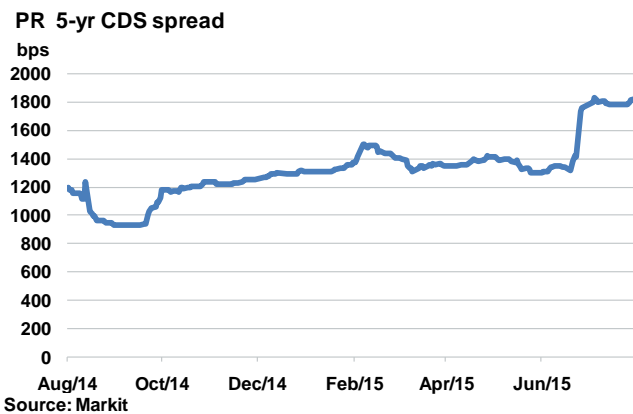
A missed payment over the weekend potentially leaves PR GO bonds in a perilous situation, but the wider municipal bond market remains stable.

- Puerto Rico’s 5-yr CDS spread has widened back to 2015 highs; GO bonds get cheaper
- MCDX has remained flat, while ETF investors have returned to munis after June outflow
- Chicago’s 2040 GO bond saw its yield spike 13bps over the weekend

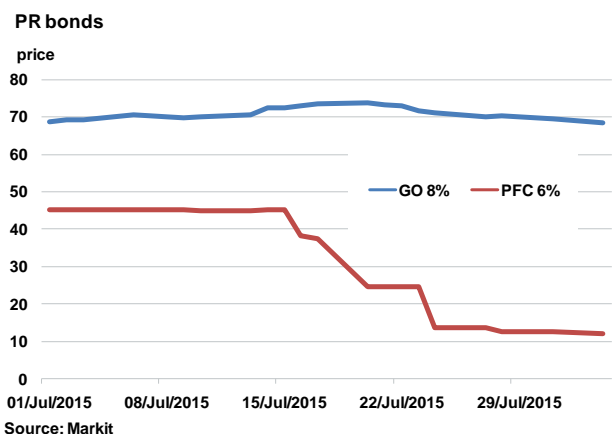
The inevitable was confirmed yesterday as Puerto Rico (PR) became the first US commonwealth to default on its debt obligations.

The US territory failed to make the full \$58m payment due August 1<sup>st</sup> on one of its Public Finance Corporation (PFC) bonds. It was only five weeks ago that PR’s governor said that its debt burden was unsustainable and that the only viable option would be to restructure the \$72bn debt load.

The missed payment would put PR into default [according to rating agencies](#) even though the PFC bonds have looser covenants than the General obligation (GO) bonds. This can be seen by looking at wide yield differential between the bonds.



Credit markets have been factoring in the heightened probability of default since the end of June. PR’s 5-yr CDS spread peaked at a record 1830bps on July 8<sup>th</sup> before tightening 51bps in the subsequent week as it scrambled to make repayments. The weekend’s missed payment on the PFC bond has seen PR’s credit spread widen 26bps over the last three days; only 5bps short of the peak 1830bps level.



The price of PR’s 8% GO bond due 2035 has seen minimal movement compared to the sharp drop seen in the 6% PFC bond due 2024. The PFC bond now trades at 12 cents to the dollar (an all-time low), according to Markit’s municipal bond pricing service.

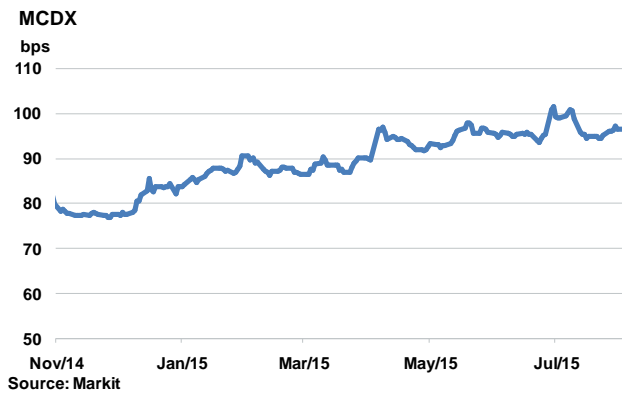
The GO bond is however 1.75 dollars cheaper than it was one week ago and has dipped below 70 dollars for the first time in four weeks. This is tied to the fact that the commonwealth released a notice yesterday stating that it has temporarily suspended monthly deposits to the GO redemption fund.

The consequences of further credit deterioration remain uncertain, but since PR

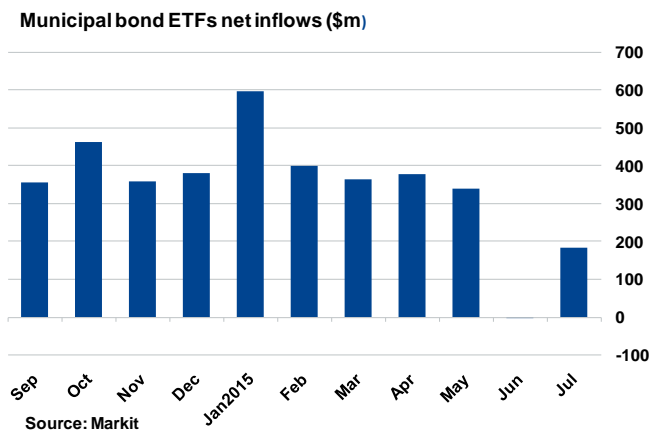
is a commonwealth and not a state, they are unable to file certain types of bankruptcy protections that states can use.

**Investors remain firm**

In bond markets, the news of default had a very minimal effect on the overall muni market, which has remained steady, especially on the long end of the curve.



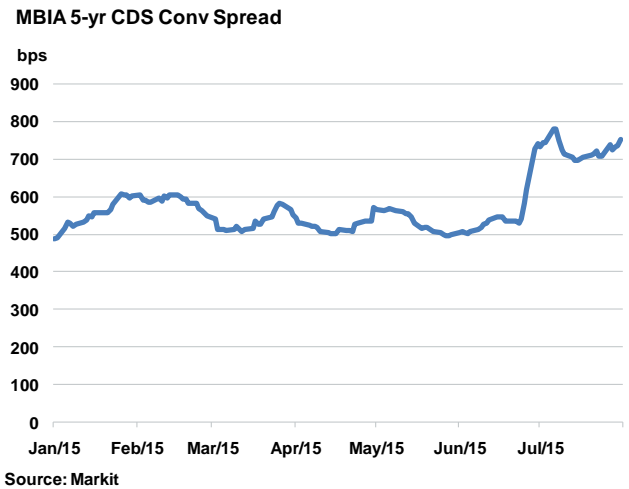
The Markit MCDX, a credit index made up of investment grade municipal CDS spreads, has remained flat, highlighting the wider market’s insulation from PR; possibly one of the reasons why federal government has so far stayed on the side lines.



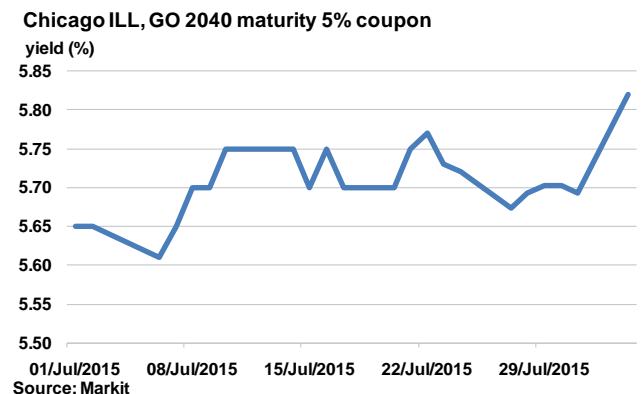
ETF investors have also returned to the asset class after showing little demand in June. July saw \$183m flow into ETFs tracking munis; bouncing back from June’s outflow.

**Possible risks**

Risks do however remain. Many Puerto Rican residents and mutual funds hold the debt and any haircut would result in individual losses. Many bond funds in the US also hold PR debt. The US government could potentially intervene by changing bankruptcy legislation if the situation continues to deteriorate.



In corporate credit, monoline insurer MBIA has seen its 5-yr CDS spread widen 37bps over the last three days to 772bps; back to levels seen at the start of July as the credit comes under renewed pressure.



Other vulnerable issuers such as Chicago, whose credit rating was [downgraded to junk](#) in May, saw its 2040 GO bond yield spike 13bps over the weekend. The yield is however still under half of that of PR’s 2035 GO bond.

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