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PUERTO RICO PUTTERS

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KEY TAKEAWAYS

Puerto Rico municipal bond price volatility picked up following the strike down of the restructuring law, as the market began to price in the prospect of a broader default.

The impact on the broader municipal market is still limited, as has been the case for much of the past 18 months.

Default risk for Puerto Rico remains but we still find the broader municipal bond market attractive.

Most individuals think of warm locations such as Puerto Rico as an escape from the snowy winter experienced in parts of the country, but the financial climate remains stormy in Puerto Rico. Puerto Rico bonds remain far from tranquil following a court ruling just over one week ago that struck down a restructuring law. The law would have opened the door for Puerto Rico's government to reduce its debt burden by restructuring government agency issued bonds, such as Puerto Rico Electric Power Authority (PREPA) and Puerto Rico Highway. This potential prepackaged default option appears unworkable.

Puerto Rico municipal bond price volatility picked up following the strike down of the restructuring law as the market began to price in the prospect of a broader default. Puerto Rico general obligation (GO) bond prices fell sharply with the 30-year bond yielding more than 10% for the first time ever according to Municipal Security Rulemaking Board (MSRB) trade reporting. On the other hand, bond prices of more depressed PREPA bonds bounced on the prospects of a more widely dispersed Puerto Rico bond "haircut."

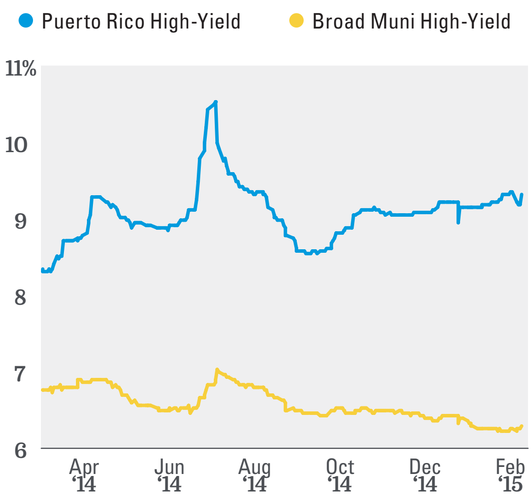
BROAD IMPACT LIMITED

The impact on the broader municipal market is still limited, as has been the case for much of the past 18 months. Yields on Puerto Rico municipal bonds, which now represent roughly 29% of the broad municipal high-yield bond market, have increased slowly but surely in recent months, reflecting the risks. In contrast, the remainder of the high-yield municipal bond market has largely ignored Puerto Rico headlines and, until late January 2015, exhibited lower yields as the sector benefited from broad bond market strength and continued improvement in municipal issuer finances. Figure 1 illustrates the divergent path in yields.

State revenue continues to increase and bodes well for the financial well-being of many municipal bond issuers. The Rockefeller Institute of Government reported that state revenue increased 4.4% for the third quarter of 2014, an improvement over the slowdown witnessed during the first half of 2014. A preliminary reading on fourth quarter 2014 revenue shows further gains with state revenue up 6.4%. Although many high-yield bond issuers are dependent on the financial health of specific projects or revenue streams, growth in state and local government revenue has generally been a positive for municipal governments despite still rising expenses. The favorable financial backdrop is another reason why the number of municipal defaults continued to decline in 2014 [Figure 2].

February weakness in both the high-quality and high-yield municipal bond market can largely be traced to the Treasury market. Treasury prices declined for six consecutive days in February, the longest stretch of declines since January 2013. The rarity of the event speaks to the strength of 2014, and an especially strong January 2015, which was likely to prompt some profit-taking. Additionally, an increase in new issuance saddled the municipal bond market with additional supply that added to Treasury-driven weakness.

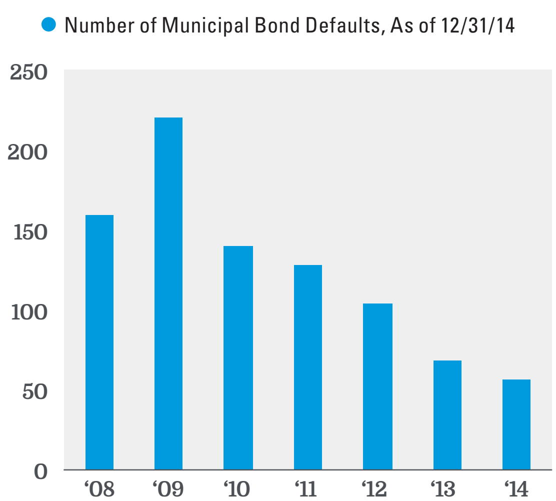
1 **PUERTO RICO CONTINUES TO HAVE LIMITED IMPACT ON THE BROAD MUNICIPAL BOND MARKET**



Source: LPL Financial Research, Barclays Index data 02/13/15

All performance referenced is historical and is no guarantee of future results.

2 **THE NUMBER OF MUNICIPAL DEFAULTS CONTINUED TO DECLINE IN 2014**

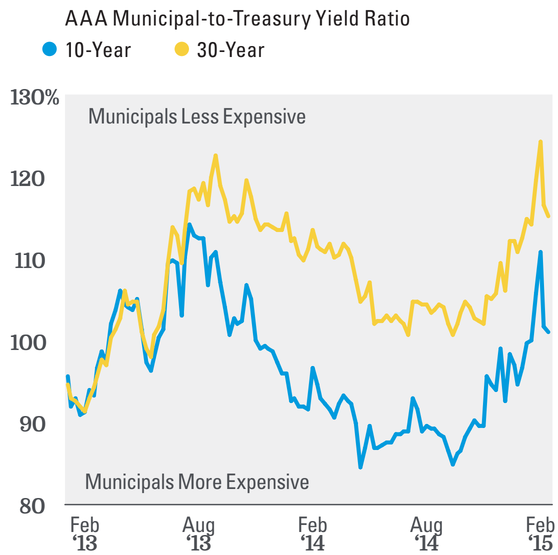


Source: LPL Financial Research, Municipal Market Advisors 02/13/15

MUNI VALUATIONS STILL ATTRACTIVE

We still find municipal bonds among the more attractive options among high-quality bonds. Municipal-to-Treasury yield ratios still remain attractive relative to recent history [Figure 3]. Municipal bonds lagged Treasuries late in 2014 and again in early 2015, as is typically the case during periods of exceptional Treasury strength. We continue to expect a challenging environment for bonds across the board in 2015, but the more attractive valuations of municipal bonds may offer better opportunity despite very low yields.

3 **MUNICIPAL BOND VALUATIONS REMAIN AT THEIR MOST ATTRACTIVE SINCE LATE 2013**



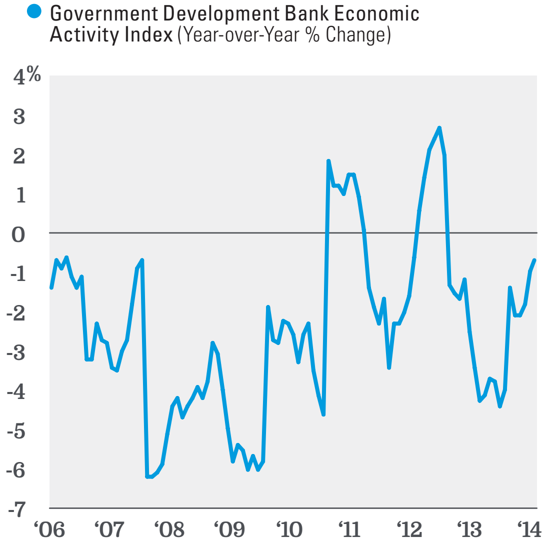
Source: LPL Financial Research, Bloomberg 02/13/15

All performance referenced is historical and is no guarantee of future results.

Different agencies employ different rating scales for credit quality. Standard & Poor's (S&P) and Fitch both use scales from AAA (highest) through AA, A, BBB, BB, B, CCC, CC, C, to D (lowest). Moody's uses a scale from Aaa (highest) through Aa, A, Baa, Ba, B, Caa, Ca, to C (lowest).

The high and rising yields on Puerto Rico municipal bonds reflect a significant risk of default in coming months and years. The Puerto Rican government is still challenged to cut expenses and spark sufficient economic growth to service a large debt burden. The Puerto Rican Government Development Bank's Economic Activity Index is very closely correlated with economic growth and indicates that the pace of weakness has decelerated but has yet to show positive improvement [Figure 4]. The government still relies on accessing financial markets to repay near-term maturities, but without economic growth, repaying a large debt burden remains a question. Last year's large debt issuance had bought the island some time. However, if economic growth does not improve, or Puerto Rico is unable to access bond markets for much needed cash, a default among Puerto Rico issues remains a significant risk sooner rather than later. ■

4 PUERTO RICAN ECONOMIC ACTIVITY HAS FAILED TO SHOW MEANINGFUL SIGNS OF IMPROVEMENT



Source: LPL Financial Research, Puerto Rico GDB 02/13/15

All performance referenced is historical and is no guarantee of future results.

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