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Debt & Disaster: Puerto Rico's Double Whammy

President Trump visited Puerto Rico last week to personally view the devastation caused by the most destructive hurricanes in memory and the federal government's disaster response efforts. In addition to handing out flashlights and paper towels, he also noted the island's massive debt and infrastructure problems, which have been percolating for years. And then in a television interview about the island's more than $70 billion in debt, he said, "They owe a lot of money to … Wall Street, and we're going to have to wipe that out."

Phot Credit: Carolyn Cole/Los Angeles Times via Getty Images

Following those remarks, which many took to mean that Trump would force bondholders to forgive the island's debt, the price of Puerto Rico's bonds, already battered by the hurricanes fell another 31%, cutting the value nearly in half. The bonds recovered somewhat after the administration's budget director Mick Mulvaney assured the markets that the U.S. government would not interfere with bankruptcy proceedings already underway for Puerto Rico. By week end, municipal bond insurers MBIA and Assurance Guarantee had withdrawn their legal complaint which had challenged the legality of Puerto Rico's bankruptcy proceedings citing the hurricane crisis.

Any way you look at it, Puerto Rico is in a terrible spot. The island's financial health began to decline over a decade ago after the territory's business-friendly tax policies changed. When the incentives that had been used to attract U.S. manufacturers dried up, many of them closed up shop and left. As a result, Puerto Rico never recovered from the 2008 recession. Besides untenable debt and underfunded pensions, a number of federal measures (domestic labor legislation, expansive welfare, and high energy costs) have further crimped economic growth and promoted outmigration as well as loss of tourism.

As they attempted to keep their heads above water in the face of a shrinking tax and economic base, many of the island's bond issuers were persuaded to lever up as the economy worsened. The combination of municipal and corporate debt and a shrinking population made a troubled economy with no growth engines even worse. Meantime, another $50 billion in underfunded pensions promised to now-retired government workers (the main remaining employer in Puerto Rico) during better days, means the island's debt load is well above $120 billion.

As a territory, rather than a city or state, Puerto Rico was initially ineligible for bankruptcy protection, so creditors began filing a series of one-off lawsuits to recoup their losses. In response, the U.S. Congress passed the Puerto Rico Oversight Management and Economic Stability Act (PROMESA) last June, a law that basically allowed the entire island to enter receivership and appointed a board to oversee the process. It was bound to be a long and drawn out affair, with the rosiest of estimates suggesting it would be a decade before all the claims were resolved, at around 25 cents on the dollar.

Puerto Rico is a textbook example of what can happen when a credit bubble bursts. As the island’s finances deteriorated, its borrowers found receptive lenders who were desperately reaching for yield in light of the microscopic interest rates. The mutual funds and ETFs that bought this debt were initially getting a disproportionate high fixed income yield by buying municipal and corporate debt securities issued by Puerto Rican borrowers. It worked well for them, until it didn’t, since investors who assume that type of risk always risk losing capital. And now those investors are faced with a market where so much junk debt was issued that there aren’t sufficient secondary buyers to mop up the distressed supply.

Moreover, unlike a corporate bankruptcy, in Puerto Rico and really with municipal bankruptcies in general, it’s difficult for an investor to realize returns, because there's not going to be any new equity issued to former creditors as occurs in corporate restructurings. So, the best that bondholders can hope for is repayment with new debt. Add to this mix a terrible local economy, a devastating storm, and Trump's bully pulpit statement threatening bondholder wipeout and the outlook doesn't look so promising.

If there is a lesson to take away from Puerto Rico, it's a point we've made before—investors need to expect the unexpected. Taking on disproportionate risk by betting on overleveraged entities without the possibility of significant upside potential can easily blow up in your face.

High junk debt yield issued during times of ultra-low interest rates only occurs when return of principal is speculative. As such, buying debt like this at par limits your upside potential while guaranteeing downside risk. There are just too many things that can't be planned for including natural disasters, labor disputes, disruption along the supply chain and spikes in commodity prices. For those "investors" who blindly bought Puerto Rican debt at par (or even above 50) and are now facing mark-to-market losses, the road ahead promises to be uncertain at best.

Remember, risk is always risky.

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