Puerto Rico's Bond Prices Are Falling Sharply, Foreshadowing U.S. Problems

Despite the fact that Puerto Rican (PR) municipal bonds are triple-tax-exempt (no federal, state, or local income taxes apply on their interest), their interest rates have skyrocketed since the Detroit bankruptcy first disrupted the complacency among municipal bond investors in July. High quality municipal bonds are paying little more than 1 percent annually, but PR bonds, even though they remain investment grade (barely), have spiked to paying between 8 and 10 percent, with some predicting that even higher rates will be necessary in order to attract new investors.

Comparisons to Detroit are tempting, but a careful look at the headwinds facing Puerto Rico makes Detroit's problems seem almost not worth mentioning. Detroit's bankruptcy filing in July was for $18 billion. Puerto Rico's debt is nearly four times larger.

A partial listing of those headwinds include:

• Moody's downgrade of PR debt on October 3 to just above junk, with its outlook changed from stable to negative;

• The recent settlement by UBS bank's Puerto Rican branch with the Securities and Exchange Commission over hiding the country's faltering financial condition and artificially supporting bond prices;

• The necessity by Puerto Rico treasury officials to borrow in the private market because the bond market is essentially closed to them;

• The U.S.-enforced minimum wage in Puerto Rico, which makes it too expensive for business owners to hire workers, impacting the island's already high unemployment rate — a rate that is nearly twice that in the United States;

• National debt that is greater than any American state, except California (population of 38 million) and New York (population of 20 million) — Puerto Rico has a population of just 3.6 million;

• A ratio of debt to personal income (which in the United States averages 3.4 percent) is an eye-popping 89 percent;

• A labor force participation rate of just 41 percent, compared to 63 percent in the United States;

• The sharp increase in income taxes by President Alejandro Padilla in his attempt to balance the government's budget by 2016;

• Overly generous welfare and disability income programs, which discourage employment and encourage dependency;

• Bloated government, where one in five workers are employed by the government;

• The country's pension plan, which is only 7 percent funded;

• The government's cash flow, which has been negative for the past 13 years, and

• Its 2012 Comprehensive Annual Financial Statement, due months ago, has yet to be filed.

As a territory of the United States (more accurately, the relationship between the United States and Puerto Rico is that of a suzerainty), Puerto Rico therefore suffers from the welfare state mentality of its northern neighbor. The country has subsisted on handouts, special incentives (such as a tax code that, until 2006, allowed U.S. corporations with offices in Puerto Rico to send their earnings to their parent without paying corporate income tax), and triple tax exemptions that allowed the government to continue to borrow at artificially attractive rates from American investors who assumed that their investments were safe. For those investors it was the best of all worlds: In a low interest-rate environment, they were able to generate excellent real rates of return without risk to their capital.

Until now.

Most of Puerto Rico's borrowings have been absorbed by municipal bond funds run by big names such as Franklin, Fidelity, and Oppenheimer. According to MorningStar, the mutual fund tracking service, 180 mutual funds in the United States hold at least five percent of their portfolios in PR municipal bonds. Some of them, such as the Franklin Double Tax-Free Income fund, has a 60 percent exposure to Puerto Rico and has seen its value drop a harrowing 15.7 percent in just the last five months. In other words, investors in that fund have seen their capital shrink by three percent per month just since May, losing one-sixth of their initial investment.

One mutual fund manager, affiliated with UBS bank, has seen its two primary Puerto Rico funds — the UBS Puerto Rico Tax-Free Target Maturity Fund and the UBS Puerto Rico Tax-Free Target Maturity Fund II — lose an astounding 88.9 percent and 83.5 percent of their value, respectively.

The impact on borrowing costs ripple out far beyond that of a small island in the Caribbean. It is estimated that the entire municipal bond market in the United States exceeds $4 trillion. If the situation in Puerto Rico continues to unravel, interest rates are likely to rise significantly across the board, raising borrowing costs for every municipality from Dubuque to Portland.

This is the end game of government interference, subsidies, wage laws, special incentives — the end game, in other words, of the welfare state itself. In a microcosm, Puerto Rico is not Detroit, or Greece, or Spain. It is the United States itself.

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