Alert

Puerto Rico Update

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Executive Summary

- Comments from President Trump supporting severe bondholder losses have jolted Puerto Rican bond markets
- Bondholder recovery prospects already reduced from impact of Hurricane Maria
- Notable selloff in uninsured PR bonds, muted to no changes in insured PR bonds
- For now, continue avoiding uninsured PR bonds, maintain exposures to select insured PR bonds

This past summer, we published a white paper examining the Puerto Rican ("PR") fiscal crisis and its impact on the municipal bond market ("*Trouble in the Tropics: How Puerto Rico's Bankruptcy Affects the Muni Market,*" 5/30/17). Recently, new developments in PR's economic and political situation have shaken the market for its bonds, leading to significant price declines. In this follow-up, we discuss how they affect the select few PR insured bond positions we maintain and why we remain comfortable with these holdings.

Recent Developments

To recap, the Commonwealth of Puerto Rico is in the midst of a serious fiscal crisis. Years of economic decline, significant population loss, and government shortsightedness and mismanagement have resulted in a major liquidity crunch and far too much debt. As the situation deteriorated last year, Washington stepped in and established a federally-appointed Oversight Board with the power to seek a bankruptcy-like court restructuring of PR's various municipal bond debts. Although most bondholders initially hoped the Oversight Board would offer relatively creditor-friendly settlement terms in negotiations, it has since become apparent the Board will instead aggressively seek to force large cuts to PR's debt burden.

> *"We have to look at their whole debt structure. They [PR] owe a lot of money to your friends on Wall Street. We're going to have to wipe that out. That's going to be – you know, you can say goodbye to that. I don't know if it's Goldman Sachs but whoever it is, you can wave goodbye to that."*
>
> *President Trump, 10/3/17*

More recently, Hurricane Maria has been an unmitigated disaster for PR, causing significant property damage and humanitarian distress on a massive scale. Although a full assessment will take months, it is apparent the scale of the destruction will require major rebuilding and reinvestment to return to even its feeble pre-storm state. As a result, it is likely the Oversight Board will eventually seek even greater bondholder losses as a mechanism to ensure more of the PR government's budget can be redirected towards rebuilding and renewal.

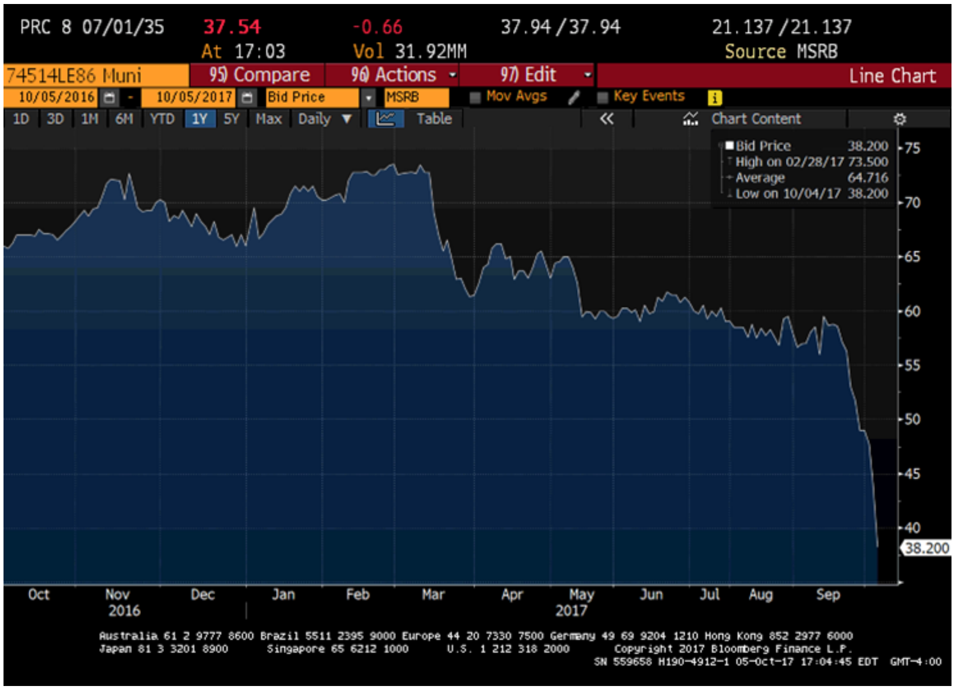
Additionally, in the wake of a personal post-hurricane visit to PR, a major media outlet quoted President Trump stating his belief that PR bondholders ought to "wave goodbye" to any prospects for recovery (see inset). Although the federal government doesn't have the legal power to unilaterally "wipe out" PR's debts, the President's comments are a strong indicator that Washington is unlikely to be any more sympathetic to PR bondholders than the Oversight Board. Any already-slim hopes of a federal bondholder "bailout" or creditor-friendly intervention in PR's bankruptcy proceedings can likely be put to rest.

Market Impact

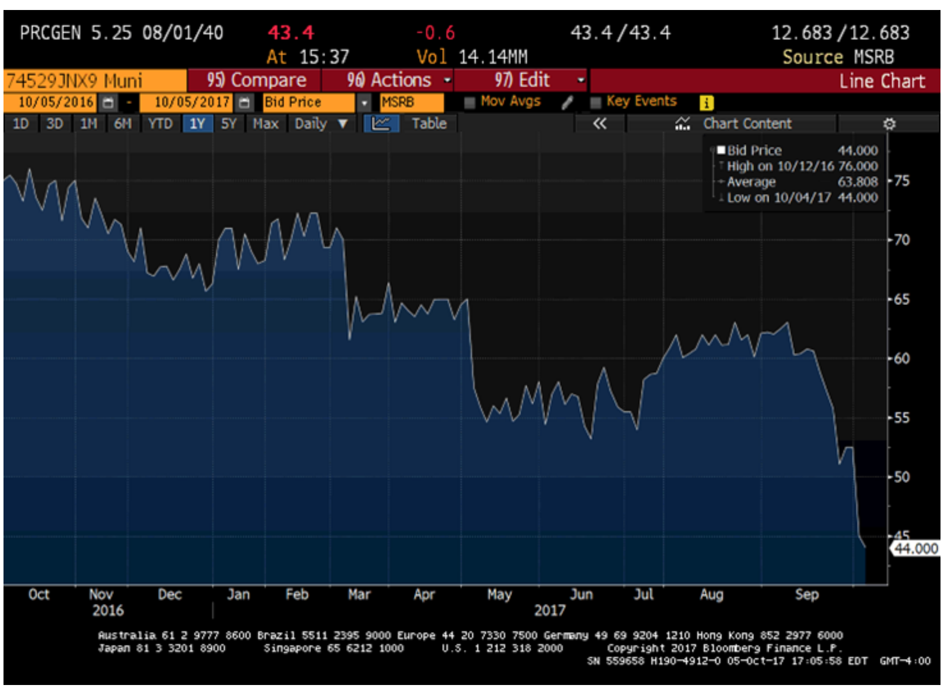
Continuing a pattern of successfully ring-fencing the fallout from the PR fiscal crisis, the broader investment-grade municipal market was unaffected by these new developments.

However, there have been significant price movements in the market for uninsured high-yield PR bonds, including those which had already been trading at distressed prices well-below par. In the past month, benchmark PR General Obligation bonds have declined from 60 to 38 cents on the dollar, while benchmark COFINA Senior Lien bonds have fallen from 63 to 44 cents on the dollar

PR General Obligation 8%s of 2035



PR Sale Tax (COFINA) Senior Lien 5.25%s of 2040



Source: Bloomberg, as of dates shown

On the other hand, at this time we see no notable degradation in the market for the investment-grade insured PR bonds that we hold. The light trading which has occurred in the past couple of days has been at prices similar to those before President Trump's remarks, which were stable, well-above par value, and far higher than comparable uninsured PR bonds.

Treasury Partners' View

In our previous PR white paper, we summarized our philosophy on investments in "bad news" issuers:

> *"We have been, and continue to be, willing to invest in issuers facing "bad news" when our analysis indicates adequate financial strength and legal protections relative to the bond's yield. Conversely, we continue to avoid those issuers where we believe the financial performance and political realities are trending towards a dangerous situation for creditors."*

In short, our positions in insured PR bonds fit the former category, while we continue to avoid uninsured PR bonds as examples of the latter category. The logic behind our insured PR holdings is based ***solely*** on our confidence in the creditworthiness and durability of the bond insurers, ***not*** on any speculative loss scenarios for the underlying PR issuers.

While a full discussion of our investment thesis is beyond the scope of this Alert, we can briefly highlight some key investment strengths of our insured PR holdings:

- Bond insurers have an unconditional legal obligation to pay its policyholders any shortfalls in a defaulted bond's debt service payments as they come due
- Policyholder payments are a bond insurer's legally senior payment obligation, whereas insurer equity prices reflect investor expectations of legally subordinate profits and dividends (which are irrelevant to policyholders)
- This obligation to cover shortfalls is not subject to acceleration and with PR bonds extends over several decades, favorably distributing the cost burden over time
- In our opinion, select bond insurers have sufficient financial reserves to comfortably cover their exposures to even the most catastrophic Puerto Rico loss scenarios

As we had already assumed the bond insurers would need to cover severe write-downs on PR debt, recent developments do not require us to change this investment thesis. Of course, we will continue to carefully monitor for events that would appear to challenge the future ability of the bond insurers to satisfy policyholder claims. In the meantime, we will continue to maintain our current insured PR holdings, and where appropriate look to add additional exposure if the market offers bonds at attractive risk-adjusted prices.