Buyer Beware

In a move that caught many observers by surprise, the Federal Oversight and Management Board (FOMB), which was created to oversee the restructuring of the Commonwealth of Puerto Rico, has requested that Judge Swain invalidate more than $6 billion of the territory's debt. The move would affect uninsured general-obligation bonds issued in 2012 and after. The rationale for the FOMB's argument is that the debt was issued in violation of the island's constitutional debt limit. While others have called for this move previously, the FOMB has never vocally supported this extreme action until now. The bonds in question were apparently issued in adherence to practices used in prior debt issuances, and their validity came into question only following the island's historic bankruptcy.

The move raises many questions. How did the island access capital markets if the debt violated the debt limit? Can the debt be invalidated if it was in compliance with practices used at the time and in prior debt issuances? If the calculations that were used were known to be incorrect, is there a case for fraud? Is there more debt the island may seek to invalidate? Is the move in line with the FOMB's mandate of putting the island on a path to regain market access? How does this development affect other municipalities that may have used creative methods to skirt statutory debt limits? The biggest question, though, is who would be held accountable? It is easy to say that this problem affects only "soulless" hedge funds, but that is not true, especially with regard to bonds issued prior to 2012, when the general-obligation pledge was still rated investment-grade. And in any case, hedge funds bought the Commonwealth's bonds based on the promise to be repaid. Being forced to take a haircut because of the inability to pay is understandable, but to get nothing because the calculations used were incorrect or inappropriate would be hard to stomach.

Whether Judge Swain agrees to the FOMB's request remains to be seen, but the attempt raises serious questions about the direction of the FOMB and the broader implications for the $3 trillion municipal bond market.

Shaun Burgess
Portfolio Manager & Fixed Income Analyst
Email | Bio

Links to other websites or electronic media controlled or offered by Third-Parties (non-affiliates of Cumberland Advisors) are provided only as a reference and courtesy to our users. Cumberland Advisors has no control over such websites, does not recommend or endorse any opinions, ideas, products, information, or content of such sites, and makes no warranties as to the accuracy, completeness, reliability or suitability of their content. Cumberland Advisors hereby disclaims liability for any information, materials, products or services posted or offered at any of the Third-Party websites. The Third-Party may have a privacy and/or security policy different from that of Cumberland Advisors. Therefore, please refer to the specific privacy and security policies of the Third-Party when accessing their websites.

Sign up for our [FREE Cumberland Market Commentaries]()

Cumberland Advisors Market Commentaries offer insights and analysis on upcoming, important economic issues that potentially impact global financial markets. Our team shares their thinking on global economic developments, market news and other factors that often influence investment opportunities and strategies.