ECONOMY

Turning the Year of the Pig into *Lechón Asa'o*

THINK STRATEGICALLY:

The Year of the Pig & POBs

President Proposes New Legislative Initiatives, U.S. Gov't Shutdown Looms, Markets Mostly Flat; P.R. Pension Bonds: A History

BY FRANCISCO RODRÍGUEZ-CASTRO | frc@birlingcapital.com

The year of the pig

On the Chinese zodiac, 2019 is the year of the pig, which started Feb. 4. A pig represents luck, overall good fortune, wealth, honesty and general prosperity. For the year of the pig, the expectation is that wood and earth industries will perform well. Among them, these include fashion, media, education and environmental sectors. Other sectors expected to play well are property, mining, insurance and computer software. Industries that may underperform include water, metals, shipping, transportation and communications. The year of the pig marks the termination of fire, according to experts. Therefore, the forecast is that the general economy may become gloomy. Looking back in history, the last year of the pig, in 2007, marked the start of the Great Financial Crisis, often called the Great Recession. In Puerto Rico, we could call it the year of *Lechón Asa'o* because roasted suckling pig is always a good omen.

Week in markets: Int'l stocks underperform; EU cuts economic growth

Along with the year of the pig, concerns about the European Union's economic slowdown came rolling in as the EU Commission slashed economic forecasts from 1.9 percent to 1.3 percent, which is a result of continuing trade tensions and other domestic risks facing the Eurozone. The Dow Jones Industrial Average closed the week at 25,106.33, a rise of 42.44 or 0.17 percent; and the S&P 500 closed at 2,707.88, a gain of 1.35 or 0.05 percent. The Nasdaq closed at 7,298.20, or an increase of 134.05 or 0.47 percent. Meanwhile, the U.S. Treasury's 10-year note went down to 2.63 percent, or a decrease in yield of minus-1.87 percent.

As we had forecast in our recent year-ahead column, we were expecting the Eurozone to downgrade its economic outlook. For instance, with less than two months to go before the United Kingdom is due to leave the EU, most U.S. American corporations have made public warnings that they are expecting a disorderly departure, and that will impact most international business. The increased risk that the UK will leave the EU without a deal is becoming quite apparent. Another blow to the UK was the recent report that Jaguar/Land Rover reported its fourth-quarter loss and informed that it wrote down $4 billion due to a diminished outlook for sales across several of its key lines. Jaguar/Land Rover is not alone as Toyota, Daimler, Volvo and Fiat Chrysler all reduced their profit expectations, mostly due to trade tensions and changing tastes in consumer behavior. Another matter having an impact on the markets is the news that President Trump may not be meeting with China's President Xi Jinping before the March 1 deadline, when the tariff increases are scheduled to go into effect, with investors closely monitoring the outcome of negotiations that are still ongoing, and both sides seem willing to reach a trade deal. As global growth concerns are revised, the strength of the U.S. dollar rose supported by the fact that 72 percent of U.S. companies beat their earnings per share.

Because the stock market started 2019 with a bang, with all barometers growing by double-digit percent in January, the Dow Jones Industrial Average grew at 10.87 percent, the S&P 500 grew at 10.57 percent and the Nasdaq grew at 12.38 percent.

Increased market volatility creates opportunities.

Following a problematic year-end 2018, we note that most stocks have increased north of 14 percent since December, due in part from the double-digit growth in the indices. We must point out that January was the sixth-most-active month of this Bull Market, which is further evidence that buying opportunities come immediately following a downturn.

Will the Bull Market last?

While it is too early to tell, we should point out that if you examine all Januarys for the past 75 years, in 65 percent of those years, January posted strong gains, and 92 percent of the time, the market finished the year in positive territory.

Market Close Comparison	2/1/19	2/8/19	Change
Dow Jones Industrial Average	25,063.89	25,106.33	0.17%
Standard & Poor's 500	2,706.53	2,707.88	0.05%
Nasdaq	7,263.87	7,298.20	0.47%
U.S. Treasury 10-Year Note	2.68%	2.63%	-1.87%

What are the drivers of growth?

- 72 percent of corporations had better-than-expected earnings in every sector.
- The decision by the Federal Reserve Board's Open Market Committee to keep interest rates unchanged.
- A strong labor market with increased job growth.

Trump's State of the Union; shutdown looming

While President Trump was giving his State of the Union Address, he mainly discussed many of the same issues that provoked the partial government shutdown. However, he touched on several key issues that have the potential of seeing legislative advances—if enough Democrats are committed to them. Among them, the President mentioned:

- Ending the HIV/AIDs epidemic within 10 years.
- Full combat against childhood cancer.
- Implementing a mandated family leave policy.

All these issues appear to have some bipartisan support and may be addressed as the President submits his budget requests to Congress.

As its Feb. 15 deadline quickly approaches, Congress must pass a funding bill to keep the government open or risk facing another shutdown.

Final Word: The real story on POBs

As Puerto Rico faces its government bankruptcy, its total debt burden, with $73 billion of debt and unfunded liabilities of $49 billion, add up to $122 billion.

One issue that is revealed every time are the Pension-Obligation Bonds (POBs), with most mentioning the fees generated for investment banks, advisers, law firms and anyone else who was involved in the side of providing much-needed liquidity to the Government Employees Retirement System (ERS). For a long time, some people made it their mission to destroy all those involved—even unmercifully attacking corporations in the private sector when they were supplying a government-requested service.

We want to point out several key issues that have not seen the light of day

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and, if they did, it would be an inconvenient truth for the government.

Another fact that must be clarified is that it was the Puerto Rico government's job to protect its credit standing in the capital markets. Had the government made sure it spent less money than it received, and took care of its wasteful spending habits, the story for Puerto Rico would be much different. If you examine the consolidated financial statements of the government of Puerto Rico, you will note that since the late 1990s, the island has been accumulating deficits.

As we examine Puerto Rico's investment climate, we select the period of 2005 to 2012, when the island still had investment grade credit. We compared economic events versus the gross national product and can safely point out that the economy began to unravel in May 2006, following the Puerto Rico government shutdown that coincided with the end of Section 936 of the U.S. Internal Revenue Code. By early 2007, the Puerto Rico government experienced a credit downgrade from "BBB" to "BBB-." In 2005, Citi brought POBs to the attention of the Government Development Bank as a way to provide much-needed liquidity to the ERS. It is well-known that in the U.S. both state and local governments have much less than the necessary funding to cover more than $1.8 trillion in pension liabilities. With the same situation being faced by the Puerto Rico government—an actuarial deficit of more than $49 billion distributed among all entities—it made sense to provide a solution to its unfunded liability.

ERS funded since 1951

Something rarely discussed is the reality, since its creation in 1951, that Puerto Rico's retirement systems began operations with an actuarial deficit created through an initial accumulated credit obligation granted for pension purposes to participants who had worked for the government before the existing retirement system was established.

In 1951, Gov. Luis Muñoz Marín decided to pay the unfunded pension liability while the deficit would be amortized and reduced over 30 years, or by 1981, which did not occur. Over the years, far from addressing the deficit and its problems, numerous special laws were enacted that established minimum benefits, death benefits, adjustments to the cost of living, additional benefits for death or disability, contributions to medical plans, summer and Christmas bonuses, medicine vouchers and the granting of personal loans to beneficiaries for a total of more than $1 billion.

Over the years, these benefits continued to accumulate along with government inaction and no one to aggressively address this time bomb. In 1999, the actuarial deficit was about $6.4 billion, which forced the government to take action. Gov. Pedro Rosselló ordered the creation of the Retirement Savings Account Program, known as Sistema 2000, and in September 1999, approved the closing of the Public Employees Retirement System. The Savings Plan was applied to employees who entered the system starting Jan. 1, 2000.

No other governor followed through to attempt to fix the ERS' unfunded liability. Despite past efforts, the deficit continued to increase and, by 2009, was at $17 billion.

Perhaps the best way to explain this change is by offering an example. There are multiple cases where public servants work for a central government agency for 27 years at a monthly salary of $3,125, who decide to become assistant executive directors in another agency with a monthly salary of $9,166 and remain in office for 47 months. At the end of four years as subdirectors, they retire with more than 30 years of service.

Public servants receive a pension based on 75 percent of the average of their salary during the last three years of their service, or a total pension of $6,874.50 monthly. These civil servants manage to increase their pensions by $4,530.75 a month. If they had stayed in their previous jobs, their monthly pension would have been $2,343.75, or 75 percent of their last monthly salary of $3,125. The final result is that in only 47 months, their pensions tripled, even if it would have been mathematically impossible to accumulate this increase in benefits in such a short period. Along with the combination of all the benefits detailed above, the lack of aggressiveness to resolve the problem is now resulting in our retirees having to face material reductions to their monthly pension payments and other benefits for the government's inattention to the difficulties.

Creation, structure of POBs

Citi was the original proponent of Pension-Obligation Bonds for Puerto Rico in 2005, which was presented as a $7 billion general-obligation (GO) bond issue to be sold in the global markets and an undefined allocation to be sold in the Puerto Rico market. While this was happening, the Government Development Bank (GDB) requested legislative approval to issue GO bonds to be used for the pension obligation. The Senate passed the bill and, when it was sent to the House, the legislation was not approved, and the GDB was told it would not be supported.

Since the Legislature would not approve the GOs for the ERS, the GDB was presented a different solution. Merrill Lynch proposed the bonds could be issued directly by the Government Employees Retirement System, and thus the GDB approved the current POB structure. It was then that the GDB decided to seek opinions from its legal counsel to examine whether the ERS could issue the bonds directly, as nonrecourse obligations of the ERS that were secured solely by a pledge of participating employees' contributions, which in 2008 were paid at a rate of 9.275 percent of payroll. Once the legal opinions were in place, Merrill Lynch prepared the deal as a global issue and made several presentations to investors in the global markets.

Merrill Lynch's efforts in the global markets were allegedly hampered by the ensuing world crisis that was then taking place, and the pricing of the bonds was not amenable to the GDB. As a result, the GDB decided to bring the local Puerto Rico portion of the POBs to market through the local bank syndicate.

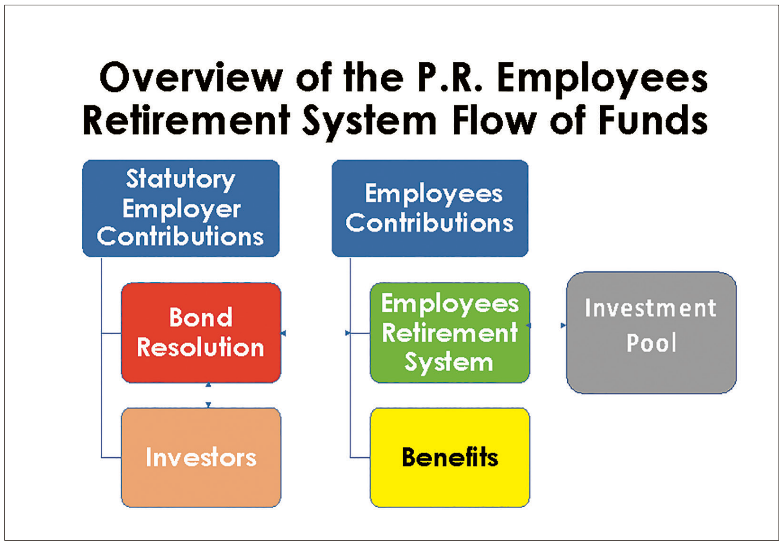
The ERS authorized the issuance of a series of bonds to increase available funds to pay pension benefits and reduce its unfunded accrued actuarial pension liability.

- On Jan. 31, 2008, the ERS issued the aggregate principal amount of $1,588,810,799.60 in Series A Senior Pension Funding Bonds.
- On June 2, 2008, the ERS issued the second of such series of bonds, which consisted of $1,058,634,613.05 in the aggregate principal amount of Series B Senior Pension Funding Bonds.
- On June 26, 2008, the ERS issued the aggregate principal amount of $300,202,930 in Series C Senior Pension Funding Bonds.
- Total issued: $2.858 billion.

All three POB issues were local and used the bank syndicate that was part of the Government Development Bank:

1. Banco Bilbao Vizcaya Argentaria P.R. (Municipal Securities Dealer)
2. Citi
3. Eurobank (Municipal Securities Dealer)
4. Lehman Bros.
5. Merrill Lynch & Co.
6. Oriental Financial Services Corp.
7. Popular Securities
8. Samuel A. Ramírez & Co.
9. Scotia Capital
10. Santander Securities
11. UBS Financial Services Incorporated of P.R.
12. Wachovia Capital Markets LLC

When the POBs were structured, their income stream was similar to Cofina's, with all proceeds of the pension payments from government agencies going directly toward payment of the POB debt. The POB provided liquidity to fund the pensions, and the government's strategy then was to utilize the $3 billion and invest it in the market using several expert money managers to handle the approach.



According to actuarial projections by Global Insight, using different scenarios, the time frame for the ERS to run out of money would be:

- 2016, if no bonds were issued;
- 2025, if only $4 billion of bonds were issued;
- 2032, if $7 billion were issued all at once, or in two issuances of $3 million and $4 million separated by a short period of time.

So the POB extended the life of the ERS significantly.

As an example, if the government had invested the funds in the Dow Jones Industrial Average in 2008, the $3 billion would have grown 327 percent, to $9.81 billion. If the government had invested in the S&P 500, it would have grown 306 percent, to $9.18 billion. If it had invested in the Nasdaq, it would have grown 512 percent, to $15.36 billion. So the actual POB transaction was not flawed; what was faulty was the government's execution of its investment strategy, which left most of the proceeds in an account in the GDB paying little or no interest.

Dispelling myths

1. Who proposed the POBs?

Citi proposed them as a general-obligation bond issue in 2005.

2. Who was the initial architect of the POBs?

Merrill Lynch was the architect of the POB structure.

3. Who selected the 12 banks involved in the POB?

Government Development Bank

4. What was the credit rating?

Standard & Poor's rated the ERS "BBB-"; S&P gave the ERS the same grade as the GOs with a stable outlook.

5. Was there a precedent with the ERS issuing bonds?

Yes, some states, counties and cities have issued POBs.

6. Was the strategy flawed?

No, the POB strategy was accurate, but not without risks; however, had it been implemented, the results would have been impressive. The flaw was GDB management's execution, which kept the POB proceeds in a noninterest-bearing account, and did not invest it in the market as was the original strategy. Had it done so, would we have the same results?

If the government had invested the funds in 2008, as was the intent, the results would have been an increase in value of $9.18 billion to $15.3 Billion

7. Why did the POBs become a political issue?

Since the P.R. House of Representatives did not pass the bill allowing the issuance of GO bonds to fund the retirement system, the GDB obtained opinions that gave the ERS the opportunity to directly issue the bonds. The House did not welcome this action.

8. What drove politicians to pursue the local banking sector?

We must remember that those who spearheaded the campaign to collect funds to pay the pension deficit was granted to former Gov. Pedro Rosselló. As those who obtained the funds went to deposit the check for the pension, the ERS, led at that time by Executive Director Juan Cancel, declined to accept the payment. This action provided the fuel for what came thereafter, with the administration of Gov. Aníbal Acevedo Vilá, the GDB, the ERS and the bank syndicate.

As can be noted, the story of the Pension-Obligation Bonds has not been adequately documented, and this overview is made to dispel many of the arguments that made the POBs a political piñata.

Francisco Rodríguez-Castro, president & CEO of Birling Capital, has more than 25 years of experience working with government, and multinational and public companies.