



4 FORECASTS,
3 THEMES &
3 REACTIONS FOR

The Last Gasp



As we share this issue of The Zenith Investor, I would like to first thank Francisco "Paco Pepe" Rodríguez Castro, President & CEO of Birling Capital for his valuable contributions to the Puerto Rico Chamber of Commerce all these years, with his collaboration and leadership in various successful investor conferences. This time, we have the opportunity to collaborate in an area where our members need timely information regarding the international markets, in line with this year's motto of taking you "Mas Allá del 100x35", taking us well beyond the boundaries of the 100x35 miles of our beautiful island. The Chamber has some stimulating activities with regards to international efforts, and we are planning significant events for this year.

Notwithstanding the uncertainty brought about by the recent government scandals, we remain confident that Puerto Rico is a viable and attractive investment destination. We continue working with the state and municipal governments to create a framework for implementing various programs, such as Opportunity Zones, and direct investment as a result of the new Incentives Code approved on June 30.

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President and Chairman of the Board
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As we write this issue of The Zenith Investor, Governor Rossello made the last gasp as he resigned last week and Secretary of State Pedro Pierluisi who was named Secretary of State when the legislature was in recess was sworn in as Governor Pierluisi using Law 7 of 1952 as amended in 2005. Since a new Governor was Sworn in there is no need to hold confirmation hearings for Secretary of State and moreover the Secretary of State was named and sworn in while the legislature was in recess, allowing his to assume the post legitimately.

In doing so, any pending confirmation hearing for Secretary of State become irrelevant as the position of Secretary of State was deemed vacant.

Although there were at least three or more arguments as to the validity or not of Governor Pieluisi's is swearing in, others question the validity of how Governor Pierluisi was sworn in, for one Senate President Thomas Rivera-Schatz has filed a lawsuit requesting an injunction and to invalidate Pedro Pierluisi's swearing-in as Governor.

The Supreme Court has heard the argument and unanimously concluded that Law 7 of 1952 as ammended in 2005 was unconstitutional and Pedro Pierluisi must abandon the post of Governor effective August 7, 2019 at 5:00 pm. In the opinion written by Associate Justice Rafael L. Martinez, states that the appointment of the Secretary of State during a recess of the legislature is not constitutional. The Secretary of Justice Wanda

Vazquez, Esq will be sworn in as Governor. The bigger reality is that Puerto Rico is traveling in uncharted territory.

Before all this was going on, there was a poll taken that placed Pedro Pierluisi versus Thomas Rivera-Schatz, the survey showed Pierluisi with 89% and Rivera-Schatz with 2%.

As I was writing this column, it made me think of some great advice my grandfather Tito Castro, a General Contractor, once told me. When I started my career in business, he said to me: "Before you make any decision or consider any action, stop for a second to think; is this decision I am making will my wife, parents, children or family, would this action make them proud or embarrass them, If you have a single doubt in your mind, do not do it."

This simple thought process has served me well all my life, and even though like all human beings, I am not perfect, but it has allowed me to consider decisions counting all constituents in my life.

Forecast 1: Manufacturing to continue sliding:

The U.S. Manufacturing PMI fell to 50.0 in July 2019, below the 51.0 expectation and with it reaching the lowest numbers since September of 2009. Overall output has contracted at a rapid pace like that of August 2009. New work from abroad declined at the fastest pace since April 2016. Employment decreased in the sector for the first time since 2013.

The resulting weakness in the manufacturing sector is the result of the U.S.-China Trade war and its impact on overall global trade impacting manufacturing significantly. U.S. manufacturing activity has declined for the fourth consecutive month in July as demand has weakened as the ongoing U.S.-China trade instability has affected manufacturers. The U.S. factory index or PMI fell to the lowest point since 2016 and has dropped 0.5 percent to a level of 51.2. We note that new orders increased to 50.8 and production; employment decreased to 51.7, and manufacturers' backlog fell to 43.1.

As a rule, a number above 50 indicates expansion and below 50 signifies a contraction.

Forecast 2: Trade Tensions to Create Huge Volatility What Should Investors Look for the year-end?

- **Economic Growth**- the U.S economic data even though the growth has slowed from 3.1% GDP in 1Q19 to 2.0% in 2Q19, it was above the analyst's consensus 1.8%.
- **Consumer Spending**- has increased from the first quarter of 2019, during which personal consumption expenditures grew by \$37 billion. In 2Q19 Personal consumption, expenditures came in at \$13.241 Trillion, an increase of \$138 billion from the 1Q19. This is the brightest spot.
- **Rate Cuts**- since the early 70's the stock markets, in general, have responded quite favorably when rates are cut.
- **Jobs Growth**- continues as reported by the Bureau of Labor Statistics the U.S.

Economy created 164,000 new job in July this compares with the consensus of 165,000 by analysts, 1,000 shy of the target, While this job growth is less than the one reported in June 193,000 it is still above the threshold of 110,000 that is needed to sustain economic growth rates.

- **Trade Tensions Subsiding or escalating**- While the U.S. and China trade war continues of analysis shows that a trade deal is likely to happen sooner rather than later, the final resolution to this trade war will sustain market growth and allow for continues trade expansion.

Every investor must be vigilant and understand the metrics that impact their investments under any scenario; this applies to your 401k, IRA, brokerage accounts, Insurance policy, and all stock market instruments. Some events in the markets create volatility or price swings that impact your portfolio; however, understanding the dynamics allows you to adjust your direction. We always recommend staying invested and adapt to a diversified portfolio that includes the right mix of stocks and bonds in line with your time horizon, risk tolerance, and investment goals.

The keywords are "diversify, stay invested, and stick to your long-term goals."

Forecast 3: Puerto Rico's is missing the Small & Midsize Entrepreneurs and middle-class spending power it needs:

Puerto Rico used to be the Caribbean's most prosperous island, but it is on the verge of being overtaken by other islands that were poorer than Puerto Rico. Now we have lost ground since the early 1990s despite many initiatives to foster growth, the decade long negative economic growth and the unequal distribution of the taxation to middle-class citizens and small and midsize corporations (SMEs)

For Puerto Rico, the unequal distribution of the share of tax liability to both middle-class citizens and SME's is holding the islands potential back. In the U.S. a large part of its success it the robust creation of SME's companies and a solidly positioned middle class with growing spending power. For Puerto Rico to advance shortly, we must harness and expand the pool of modern, competitive firms that can create better-paying jobs, and increase middle-class demand needed for new investment. The creative disruption created by social media, digital technologies, globalization, the efficiency of delivery provides a platform to develop a circle of wealth and growth. However, this requires reforms to help companies compete, and workers prepare.

In the aftermath of Hurricane Maria, more than 15,000 SME's closed most never reopened and 4 out of 10 Puerto Ricans lost their jobs, although job growth has increased in recent months.

What do we need :

Take Parallel 18 Islandwide- Parallel 18 in an entity that supports startups and accelerates their growth by promoting and fostering entrepreneurs in Puerto Rico. Startups from 48 countries have applied to Parallel 18, and according to them, those that have gone through their program have obtained results beyond expectations. We propose to take Parallel 18 Islandwide to the principal eight municipalities, by doing so it will increase the creation of entrepreneurs in Puerto Rico.

- **Share of Firms and Employment:** In most countries, SME's entrepreneurs account for the majority of firms and a large percentage of employment. From Ecuador to Greece, for example, firms with fewer than 50 employees accounted for 99% to 60% of all firms and 55% to 70% of Total employment. This metric could easily be expanded in Puerto Rico by allowing all SME's to set up shop without the need for a protracted permits process. SME's should be allowed to commence operations once created and approved by a centralized government entity.
- **Job Creation:** massive changes to the SME's must be targeted to allow them to thrive and double the job creation potential that they now possess.
- **Adapting to Changing Climates:** small businesses

possess the ability to respond and adapt quickly to changing economic climates and consumer sentiment. Most small businesses have a good reading of consumer preferences and better understand the needs and aspirations of communities they serve. Most local consumers remain loyal to their favorite SME's most, especially during trying times. The benefit of this loyalty is that usually, these businesses often can sustain growth or stay open during hard times, this behavior further strengthens local economies.

- **Globalize and Export as a way to expand:** is one way to increase productivity and scale-up. Firms experience quantitative productivity increases after entering international markets by benefiting from scale economies, knowledge exchange, and technical spillovers. SME's that export have raised productivity by more than 25%. While the SMEs are not themselves exporting, that involvement gives these smaller firms productivity-enhancing access to information and technology.

Forecast 4: China is labeled as Currency Manipulator nation as a direct effect of the trade war, What comes Next?:

The United States Treasury Department took the unusual step of labeling China as a currency manipulator as China made concrete

steps to devalue its currency as a direct effect of the U.S.-China Trade war. The renminbi fell to the lowest level in more than twelve years. According to Treasury Secretary Mnuchin, the U.S. will now engage with the IMF to eliminate any unfair advantage created by China's currency manipulation actions.



While the labeling of currency manipulation is mostly symbolic, it does create havoc to the stock markets, and it does hinder international trade and the overall Global Economy.

Nonetheless, neither side can claim a clear victory. However, when reviewing data from other countries, some significant winners in the trading scene.

Theme 1: What is driving the markets?

- **As investors continue to expect central banks around the world, including the U.S. Federal Reserve Bank:** will implement a monetary easing policy with reduced interest rates, that expectation will continue to drive markets to new highs.
- **The European Union:** which has been suffering from a sluggish economy, policymakers such as David Lipton, the current acting CEO of the International Monetary Fund, has stated the

need for a stimulus from the world's central bank systems to prop up the economy.

- **The European Central Bank:** has been considering reducing its interest rates and some form of quantitative easing. Now is the appropriate time to rebalance portfolios to position them to face the lower interest-rate environment.
- **While we believe for the rest of 2019:** the market will continue to grow; it is advisable to review all portfolios to ensure they are well-diversified.

As the economic cycle continues its momentum, we must note that consumer spending remains at a healthy pace. Unemployment is at 50-year lows, with employment and wages rising.

What could stop momentum and impact the markets?

- **Inflation that is too low:** If inflation is too little or too high, it usually is bad for the economy; however, in our specific case, deflation may impact the current bull market. Deflation happens as demand for goods and services stalls, making prices fall. When prices fall, businesses invest less.
- **Continued trade tensions between U.S. and China:** The impact on global growth is decreasing business investment and disrupting overall trade. World trade

growth has fallen from 3.9 percent in 2018 to 2.1 percent in 2019. Even China's economic growth has slowed to 6.2 percent in the second quarter, which is its slowest pace since the 1990s.

- **Global growth rates reduced:** The impact of Brexit, trade tensions, and other political risks have created the basis for less vigorous economic growth.

With so many challenges and uncertainty, market volatility is expected to continue during the rest of the year. Our advice is for investors to prepare their portfolios to face an uncertain fate in the markets. Investors with well-defined goals, aspirations, diversified portfolios, and constant evaluation of risks should fare well during this period.

Theme 2: The Month in markets: The Month of July 2019 was good, August started with large drops.

The Dow Jones Industrial Average closed the month of July at 26,864.27 for a gain of 264.31 or 0.99 percent. The S&P 500 closed the month at 2,980.38 for an increase of 38.62 or 1.31 percent, The Nasdaq closed the month at 8,175.42, for a gain of 169.18, or 2.11 percent, meanwhile, the U.S. Treasury's 10-year note was rose slightly during the month, reaching 2.02% and gaining 1.00%. The stocks ended the month with gains; however, not as significant as the prior month. One issue that was expected to drive markets was the

Federal Reserve Bank action, and as was expected last week the FED lowered the range of its benchmark interest rates to 2.0% -2.25% from 2.25% -2.5% in an attempt to curb rising uncertainties that range from too low inflation to slowing global economic growth. However, what came after the cut is what impacted the market, as Fed Chair Powel during a press conference stated that no future rate cuts were likely during the rest of 2019. Immediately the market showed the disapproval to their policy by delivering the worst week in 2019.

As the losses extended during the week, another obstacle was placed by President Trump as he announced another round of tariffs on Chinese imports.

The new tariffs announced by the U.S. place a 10% tariff on \$300 billion worth of Chinese goods starting in September and China soon made it owns countermeasures.

With an increase in volatility as a direct response to trade tensions between two of the world's economic powers, However, investors should note that this just one risk in a mixed bag of threats that surround the markets. We must also consider other risks such as liquidity, concentration, credit, inflation, among other risks that all investors should be mindful of them.

The investors must consider a broader view of their timeframe to accurately assess their prospects and investments returns.

Market Close Comparison	7/31/19	6/28/19	Change
Dow Jones Industrial Average	26,864.27	26,599.96	0.99%
Standard & Poor's 500	2,980.38	2,941.76	1.31%
Nasdaq	8,175.42	8,006.24	2.11%
U.S. Treasury 10-Year Note	2.02%	2.00%	1.00%

Theme 3: The New Puerto Rico Incentives Code Explained

On July 1, 2019, the Governor of Puerto Rico signed into law House Bill 1635, known as Act 60-2019 - Puerto Rico Incentives Code (the "Act").

The Act intends to achieve the following:

1. consolidate the dozens of decrees, incentives, subsidies, rebates, or existing contributory or financial benefits;
2. promote the environment, opportunities and the appropriate tools to promoting the sustainable economic development of Puerto Rico;
3. establish the legal and administrative framework governing the request, evaluation, grant or denial of incentives by the Commonwealth of Puerto Rico;
4. promote effective and continuous measurement of the costs and benefits of incentives to maximize the impact of public funds investment;
5. give stability, certainty and credibility to the Commonwealth of Puerto Rico in all the way to private investment; and
6. improve Puerto Rico's economic competitiveness.

The Act recognizes that it is imperative to encourage effective and continuous measurement of the costs and benefits of the incentives granted, in order to determine the cash invested *vis a vis* what the Commonwealth receives. Therefore, the Act will also incorporate provisions to measure return on investment (ROI) and maintain up-to-date data on such performance by economic sector.

An incentive assessment model will also be created, according to the needs of Puerto Rico's economy, to measure the effectiveness of the program based on the annual reports submitted by beneficiaries. Analysis of the reports will allow stimulus programs to be improved and will ensure that incentives are allocated and used to maximize the economic impact on the island. The evaluation will also facilitate compliance with the terms and conditions of incentives granted, including the measurement of risk and return on investment of such stimulus, related to the economic public policy development. Another of the changes envisaged in the Act is the incorporation of rigorous safeguards to impose defined penalties for non-compliance with any of the terms and conditions of the incentive contract, including failure to comply with the submission of the annual reports.

Another of the priorities in adopting the Act is to facilitate the transition so that most of the processes are automated and focused on a system that allows multiple users, such as proponents, service providers, agencies and other stakeholders, have access to public information and can conduct transactions efficiently. The Act formally incorporates private sector participation in the process by creating the figures of the Qualified Promoter and the Certified Professional, who will assist the Commonwealth in attracting companies to the island and facilitating the application and compliance processes.

Some changes to the economic incentives, include organizing exemptions by segment and sectors of industries, so that several incentive laws can be grouped within the same category, as follows:

1. Individuals
2. Export (Services and Goods)
3. Financial and Insurance Services
4. Visitor's Economy
5. Manufacturing, including the R&D component
6. Infrastructure
7. Agriculture
8. Creative Industries
9. Entrepreneurship
10. Other

Rates are also harmonized as far as possible across industries, to provide several contributory benefits that as a rule apply to all sectors, providing a simple guide on what is offered and to whom. The term of tax exemption decrees is also standardized so that everyone has a 15-year term with a possible renegotiation for an additional 15-year term.

The power to grant decrees and the regulation of the Act is centralized in the Department of Economic Development and Commerce ("DDEC"), providing that tax and contributory matters will be worked in conjunction with the Department of Treasury. All changes established by this Act are for the prospective nature and do not affect companies or individuals with decrees, credits, or incentives granted before approval.

The Act includes the Cuenta Mi Futuro. Through this new program, the Commonwealth will open an account with a thousand dollars (\$1,000) to each kindergarten student in the public education system. This account will allow children to accumulate savings they will receive once they graduate from high school. These funds could be used, among others, to start college, or to start a business. This is a mechanism to continue the fight against social

inequality, school dropouts and encourage academic performance.

The Act also includes a program to repay student loans to doctors, veterinarians, dentists and scientific researchers in the area of health to stay in Puerto Rico after completing their education. To this end, DDEC may provide a grant on student loans incurred by these physicians, subject

to them remaining in Puerto Rico and establishing their practice here. With this measure, the Commonwealth tries to reduce the exodus of doctors and specialists that Puerto Rico has been seeing a few years ago.

The Act is effective from July 1, 2019. New applicants may elect to file under previous laws or under the Act until December 31, 2019.

Commencing on January 1, 2020, all applications will have to be submitted under the Act.

If you need specific information related to your industry, please contact CPA Cesar E. Hernandez, Esq. chernandez@birlingcapital.com or call Birling Capital Advisors.

The Final Word: Three Governors or maybe four in three weeks?

As the Supreme Court determined that Law 7 of 2005 under which Pedro Pierluisi was sworn in as Governor was unconstitutional, it seems evident that as of 5:00 pm on August 7, 2019, Secretary of Justice Wanda Vazquez should be sworn in as the new Governor of Puerto Rico. This action might lead you to assume that this might mean the end of the crisis, however one of the arguments of the Senate President Thomas Rivera-Schatz had been that Pedro Pierluisi was only partially confirmed and did not follow the correct due process. As Secretary of Justice Wanda Vazquez becomes Governor at 5:00 pm it's worth noting that she was like Pierluisi confirmed by the Senate, not both the House and Senate.

Senate President Thomas Rivera-Schatz who initiated the lawsuit to determine the unconstitutional nature of Law 7 of 2005 has made his position quite clear. In a recent press release stated the following: "To those who, despite the clarification of the facts and the law, do not want to accept the truth." He also said, "Puerto Rico is above everything, Now, we will continue the work agenda for a better Puerto Rico with Jennifer González Colón and all the elected leadership of the New Progressive Party."

This statement leads us to predict that Resident Commissioner Jennifer González will be nominated Secretary of State and once confirmed by both the House and Senate, soon to be Governor Wanda Vazquez will resign to allow Resident Commissioner Gonzalez to become Governor. We predict that before the month ends Commissioner González will be Puerto Rico's Next Governor, the fourth in as many weeks. We believe that the people of Puerto Rico would favor an elected official would be a more legitimate candidate than an appointed official. In Jennifer Gonzalez case she was the elected official that obtained the most votes during the 2016 elections as she received 718,591 votes which when compared to former Governor Rossello who won with 660,510 or 58,087 fewer votes than Jennifer González. As under the current circumstances where the whole world is watching Puerto Rico, we must do the right transition of power.

As we said before, this would be The Last Gasp.

We hope that you have enjoyed this issue of The Zenith Advisor © and we very much welcome your comments, thoughts, and ideas; you may reach us at frc@birlingcapital.com or 787-247-2500.



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