INDUSTRIALES PUERTO RICO
MANUFACTURA SERVICIO COMPETITIVIDAD

BIRLING CAPITAL ADVISORS, LLC

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The Mercurial Investor©

5 FORECASTS, 9 THEMES & 9 REACTIONS FOR 1Q19

On this issue of The Mercurial Investor, we note that in 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. However, that is fiction.

One of the metrics that was delayed due to the Government Shutdown was the Gross Domestic Product numbers that reached an annualized pace of 2.6 percent during the fourth quarter of 2018, a growth less stellar than the 3.4 percent in the previous quarter. The full-year growth rate of 2.9 percent was below the 3 percent goal stated by President Trump.

For this issue Birling Capital has outlined five forecasts that will have significant implications for global markets:

Forecast 1: Investors Cautiously Optimistic of U.S.-China Trade Talks:

The U.S.-China trade negotiations deadline is March 1 and we note President Trump indicated, "I am pleased to report that the U.S. has made substantial progress in our trade talks with China and we will be delaying an increase in tariffs on Chinese imports; and we will be planning a summit at Mar-a-Lago to conclude an agreement."

With so much economic data available, we must wait for the results to measure the impact on the markets.

Forecast 2: 7.35 Million Job openings reached a record high in December: this is another strong signal of the economy, with a strong labor market is a critical signal that supports modest economic growth. However, investors must be vigilant of other economic indicators that predict a slowdown.

Forecast 3: 72 Percent of S&P 500 Companies Reporting Earnings Growth:
With 72 percent of S&P 500 companies having reported fourth-quarter results, earnings have grown at a 13% clip compared to a year ago. The five straight quarters of double-digit earnings growth. 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

Forecast 4: These are the drivers of growth.

- Corporations earned better-than-expected earnings in every sector.
- The decision by the Federal Reserve Board's Open Market Committee to keep interested rates unchanged.
- A strong labor market with increased job growth.

Forecast 5: Donald Trump to name a new Financial Oversight and Management Board:

- The First Circuit Court of Appeals held that the appointment of all members of the FOMB was unconstitutional. However, the Court stopped short of dismissing the Title III cases and gave 90 days for the FOMB to be reappointed or reconstituted.
- The FOMB was due to be re-nominated by August of 2019.
- The Big Change the ruling makes is that before the House and Senate could each nominate three members while President could nominate one member, Now President Trump can nominate all seven members of the FOMB.
- Will President Trump re-nominate the current board or will it select new members of his choosing and start anew, knowing President

Trump get ready for a new FOMB.

Theme 1: The world economy is on the route for a period of low growth.

The eurozone growth is expected to slow to 1.3 percent this year from 1.9 percent in 2018 and is expected to rebound in 2020 to 1.6 percent. Nobel laureate Paul Krugman warned that the world economy is headed for a recession later this year or early next year. Recent data points to declining business confidence are Germany, France, and Italy.

Theme 2: Puerto Rico is not alone with the Informal economy; let's take a look around the world:

Today, two billion workers, or 61.2 percent of all workers in the world, are in the informal economy. The informal economy involves all economic activities by workers and economic units that are, either in law or in practice, not covered by formal arrangements. Its high heterogeneity primarily characterizes it. The informal economy is the reality of more than 85 percent of self-employed workers and one out of two employers. Their economic units are not legally recognized; they face non-compliance with fiscal obligations as well as serious difficulties in engaging in commercial contracts and gaining access to financial resources, markets or property. It is also the reality of 40 percent of employees whose employment relationship is, in law or practice, not subject to national labor legislation, income taxation, social protection, or entitlement to certain employment benefits. Informality is, finally, the reality of all contributing family members, who are considered as having informal jobs by definition.

Informality has multiple adverse consequences for individuals, firms, and societies. Individuals who work informally are exposed to pervasive decent work deficits and limited access to social protection. Enterprises that operate informally are a source of unfair competition for those enterprises that comply with fiscal and labor laws. Besides, they face high barriers in terms of access to capital, financial resources, public infrastructures, and markets, with negative implications for productivity and business sustainability. Finally, for Government and societies, informality means reduced government revenues.

Theme 3: U.S. Consumer Confidence hits an 18-Year High:

The Conference Board Consumer Confidence Index® increased in February to an 18-year high and blew away all forecasts, following declines in the preceding last months. The Index now stands at 131.4, up from 121.7 in January an 8 percent increase. Birling Capital's Economic Poll had called for a rise of 126.2. The Present Situation Index – based on consumers' assessment of current business and labor market conditions – improved, from 170.2 to 173.5. The Expectations Index – based on consumers' short-term outlook for income, business and labor market conditions – increased from 89.4 last month to 103.4 this month.

"Consumer Confidence rebounded in February, following three months of consecutive declines," said Lynn Franco, Senior Director of Economic Indicators at The Conference Board. "The Present Situation Index improved, as consumers continue to view both business and labor market conditions favorably. Expectations, which had been negatively impacted in recent months by financial market volatility and the government shutdown, recovered in February. Looking ahead, consumers expect the economy to continue expanding. However, according to The Conference Board's economic forecasts, the pace of expansion is expected to moderate in 2019."

Consumers' appraisal of current conditions improved moderately in February. Those stating business conditions are "good" increased from 36.4 percent to 41.2 percent, while those saying business conditions are "bad" was unchanged at 10.8 percent. Consumers' assessment of the labor market was mixed. Those stating jobs are "plentiful" decreased slightly from 46.7 percent to 46.1 percent, while those claiming jobs are "hard to get" also decreased, from 12.6 percent to 11.8 percent.

Consumers' optimism about the short-term future rebounded in February. The percentage of consumers expecting business conditions will improve over the next six months increased from 16.3 percent to 19.7 percent, while those anticipating business conditions will worsen decreased from 13.8 percent to 8.9 percent.

Consumers' outlook for the labor market was also more favorable. The proportion expecting more jobs in the months ahead increased from 15.3 percent to 18.5 percent, while those anticipating fewer jobs declined, from 16.2 percent to 12.2 percent. Regarding their short-term income prospects, the percentage of consumers expecting an improvement rose from 17.7 percent to 20.0 percent, but the proportion expecting a decrease also increased, from 6.8 percent to 8.5 percent.

Theme 4: Monetary policy Federal Reserve Bank's Semiannual Monetary Policy Report to the Congress: Fed Chair Powell mentioned in his remarks the following topics.

- The second half of 2018, as the labor market kept strengthening and economic activity continued to expand sharply.
- The FOMC gradually moved interest rates toward levels that are more normal for a healthy economy. Specifically, during September and December.

- The FOMC decided then to raise the target range for the federal funds rate by 1/4 percentage point at each, putting the current range at 2-1/4 to 2-1/2 percent.
- The FOMC December meeting, they stressed that the extent and timing of any further rate increases would depend on incoming data and the evolving outlook.
- In January the FOMC noted that with inflation pressures muted, they determined that the cumulative effects of these developments, along with ongoing government policy uncertainty, warranted taking a patient approach.
- The Fed stated that going forward, policy decisions will continue to be data dependent and will take into account new information as economic conditions and the outlook evolve.

The February Monetary Policy Report gives an update on monetary policy rules. However, the Fed systematically conducts monetary policy to promote their long-run goals of maximum employment and stable prices.

The Fed Chair stated that they would continue to use administered rates to control the policy rate, with an ample supply of reserves so that active management of reserves is not required.

Theme 5: Global Trade Growth Morphs with the increase in trade tensions.

Global trade growth is moderating alongside rising trade tensions among the world's largest economies and tightening monetary conditions that are escalating financial fragilities in some emerging economies. The global trade performance peaked in 2017, expanding by 5.3 percent in volume terms, which is above the average growth in the last half-decade.

Theme 6: Structural Reforms needed for Puerto Rico:

The serious structural problems facing Puerto Rico require major reforms of various systems that impact our development, including those related to the size and functions of government. As a benchmark of the amount of reform needed let review our tax system and compared to other nations. In the World Bank's Paying Taxes 2018 report, Puerto Rico went down to 162 in terms of the Total Tax Rate, that includes compliance costs. Ireland is 4, Singapore is 8, the U.S. is 37 , and some of our neighbors such as the Dominican Republic is 148 ,and Costa Rica is 57.

Taking into account global trends in tax system reforms and Puerto Rico's present needs, Puerto Rico's tax system should:

- Significantly reduce compliance costs.
- Move from an income to a consumption base.
- Eliminate capital gains taxes in certain activities.
- Expense investments in productive activities.
- Integrate the Incentives Code with the tax system reform.
- Establish the grounds for eventually moving to a VAT system.
- Be comprehensive, i.e., incorporate all taxes, including municipal ones. The most recently approved tax reform for Puerto Rico does not meet the above criteria.

How Puerto Rico Post-Reconstruction Development should look like:

- An open economy such as Puerto Rico's needs to incorporate risk management as part of its economic policy-making process due to the extensive risk profile that characterizes a small and very open financial system.
- The high-risk profile integrates external factors such as technological, geopolitical, market changes and, of course, changes in U.S. social, economic and fiscal policies. Strengthening foresight capacity is essential in understanding and minimizing risks.
- A long term vision is critical for guiding strategic decisions and structural reforms.

Sustained development incorporates some objectives and integrated approaches to what is called development infrastructures.

Theme 7: Market Update- Markets Rally, Year of the Pig influencing U.S.-China Talks.

As the February closes most stocks advancing, it is noted that the U.S. stock market finished the week with increases in all market barometers we monitor. The Dow Jones Industrial Average (DJIA) closed the month at 25,916.00, a rise of 916.33, or 3.67 percent, and; the S&P 500 closed at 2,783.91, a gain of 79.81, or 2.95 percent. The Nasdaq closed at 7,532.53, or an increase of 250.79, or 3.44 percent, Meanwhile, the U.S. Treasury's 10-year note went up to 2.73 percent or a yield increase of 3.80 percent. See Table below.

Market Close Comparison	1/31/2019	2/28/2019	Change
Dow Jones Industrial Average	24,999.67	25,916.00	3.67%
Standard & Poors 500	2,704.10	2,783.91	2.95%
Nasdaq	7,281.74	7,532.53	3.44%
U.S. Treasury 10 Year Note	2.630%	2.730%	3.80%

Theme 8: Puerto Rico Systemic Risk in Healthcare

The U.S. including Puerto Rico ranks first in per capita health spending. However, we are dead last in health system performance of 11 major developed countries. Out of the total expenditure for healthcare, a whopping 38 percent goes towards hospitals and it has been the same for the last 50 years.

The most considerable challenge facing Puerto Rico hospitals, and even those in the U.S. is the fact that they are being forced to either reduce costs at the expense of creating potentially devastating impacts on the communities served or take less aggressive cost-cutting measures and risk facing severe financial hardships.

This scenario to this indubitable Hobsons Choice has developed through profound public policy and market moves that transfer financial risk into local healthcare systems. With little or no financing available in Puerto Rico, the Healthcare industry has a considerable similarity to the financial systemic risk crisis of 2008.

In our view, the most significant lesson the financial crisis of 2008 taught us, is the fact that changing rules, poorly understood interdependencies and lack of proactive management of the market forces would have dire consequences to the Puerto Rican economy and event for the U.S. economy itself. With 3.2 million U.S. citizens depending on our services that save lives we must be sure we don't have to learn that lesson again in health care.

What are the factor driving this Healthcare Systemic Risk?

- Demographic Changes (Age & Population Distribution)
- Economic Factors (Poverty & Unemployment)
- Constant Financial Pressures on Providers & Insurance Agents
- The Exodus of Health Professionals
- New Technological &Clinical Advances
- Advanced Methods for Diagnosis & Treatment
- New laws and Mandates Complicating Services & Increasing Costs
- Constant Increases in Medication Costs
- Globalization of certain diseases (ex. Infectious)
- Indifference towards prevention & change in Lifestyles

Healthcare Trends for the Future

• Dramatic changes in technology: Robotics, telemedicine, nanomedicine, information technology, etc.

• Advances in new methods of treatment: New Generation of medications, organs transplants, the human genome, stem cells, bioengineering, etc.

The Dire Financial Situation

1. Health Reform Plan depends mainly on Medicaid monies, yet has a cap by law. It is about 60% less than any state.
2. Medicare and Medicare Advantage Program. It is about 40% less than any other state.
3. Inequalities with health professionals with the same required training as in the mainland, with the same equivalent professional licenses to practice, yet: They are treated differently.

Hospital Contribution to our Economy

- 45,000 direct and indirect jobs
- $5 billio yearly
- Average of $35,000 per year in salaries to employees, without including physicians.
- Maintains the quality of lives of 3.2 million Puertoricans.

Theme 9: The Final Word: The real story of the Pension Obligation Bonds

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

One topic that is revealed every time is 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 topics that have not seen the light of day 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 a credit rating. 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 elapsing 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 unfunded since 1951

Something rarely discussed is the reality, since its creation in 1951, that the 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 Marin 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 of death or disability, contributions to medical plans, summer and Christmas bonuses, medicine vouchers and the granting of personal loans to beneficiaries of a total of more than $1 billion.

Over the years, these benefits continued to accumulate along with government inaction and no one to aggressively attend to 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.

The only other governor that made efforts to attempt to fix the ERS' unfunded liability was Governor Anibal Acevedo-Vila. 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 Under-secretaries, 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 managed 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 not attending 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 General Obligation bonds to be used for the pension liability. The Senate passed the bill and, when it was sent to the House, it was not approved, and the GDB was told the legislation 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 Themes 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 impacted by the ensuing world crisis that was then taking place, and the pricing of the bonds was too high as they were taxable and not amenable 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.

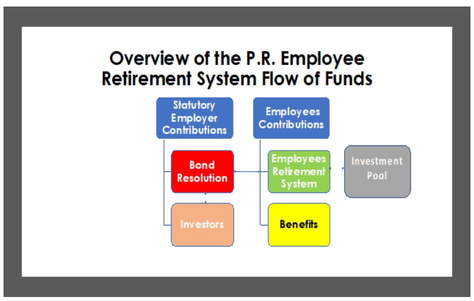
- On Jan. 31, 2008, the ERS issued the aggregate principal amount of $1,588,810,799.60 in Series A Senior Pension Funding Bonds.
- On June 2, 2008, the ERS issued the second of such series of bonds, which consisted of $1,058,634,613.05 in the aggregate principal amount of Series B Senior Pension Funding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

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

- Banco Bilbao Vizcaya Argentaria P.R. MSD
- Citi
- Eurobank MSD
- Lehman Bros.
- Merrill Lynch & Co.
- Oriental Financial Services Corp.
- Popular Securities

- Samuel A. Ramírez & Co.
- Scotia Capital
- Santander Securities
- UBS Financial Services Incorporated of P.R.
- Wachovia Capital Markets

When the Pension-Obligation Bonds 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 it indicated the time frame that the ERS would run out of money to be:

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

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:

Who proposed the POBs?

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

Who was the initial architect of the POBs? Merrill Lynch was the architect of the POB structure.

Who selected the 12 banks involved in the POBs?

Government Development Bank

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.

Was there a precedent with the ERS issuing bonds?

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

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 the value of $9.18 billion to $15.3 Billion.

Why did the POBs become a political matter?

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 Themes the bonds directly. The House did not welcome this action.

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 after that, with the administration of Gov. Aníbal Acevedo Vila, 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 look is made to dispel many of the arguments that made the POBs a political piñata.

CPA Cesar Hernández-Monagas, Principal, Birling Capital

Talking about Law 257-2018 Tax reform and Hacienda's fiscal agent duties

The explanatory statement of the recently passed law 257-2018 – Tax reform, includes the following objective: "... Another major objective of this tax reform is to reduce the cost of compliance to taxpayers, either in time or money... " But on the other hand, the law states the following: "... For years starting after December 31, 2018, the individual may claim all the ordinary and necessary expenses of his industry or business claimed to determine the net income subject to the normal contribution set out in section 1021.01, provided that you include with your income tax return a previously Agreed-Upon Procedures Report or Compliance Attestation prepared by a Certified Public Accountant (CPA) with a valid license in Puerto Rico, certifying that the expenses claimed are ordinary expenses and necessary to generate self-income... "

How does this reduce the cost, in time and/or money for taxpayers? The answer is, no, on the contrary, it increases both. The only beneficiary of this new regulation is the Treasury Department ("Hacienda"). The Legislature concluded that Hacienda is not capable of performing its role as fiscal agent and now corresponds to the taxpayers to hire a CPA to do the work we all expect from the Hacienda, as fiscal agent. We need a real tax reform in which Hacienda oversees enforcing it.

When is Hacienda going to comply with its old slogan, Hacienda para servirte…

As tax season approaches Its Time to Sell your Tax Credits

Birling leverages its in-depth knowledge of market dynamics and relevant industry trends to provide advice to clients in the United States and Puerto Rico to assist them in developing effective tax planning strategies that will minimize the tax costs of doing business in Puerto Rico. We advise clients in connection with:

- Act No. 73 Economic Development Incentives Act
- Act No. 20 Export Service Promotion Act
- Act No. 22 Individual Investors Act"
- Act No. 27 Film Industry Economic Incentives Act"
- Act No. 83 Green Energy Incentives Act
- Act No. 74 Tourism Development Act

Please contact us if you have any questions regarding your tax credits or if you need additional advice.

One Last thing: President Trump until May 16 to Act on PROMESA

During a recent speech at the 3rd PROMESA Conference held on February 22, 2019, Professor & Financial Oversight and Management Board Member Dr. David Skeel stated when asked about the recent U.S. Court of Appeals Decision. The court declared the FOMB appointments unconstitutional and when asked Dr. Skeel responded: " Unless the President makes a quick decision in less than 90 days on the appointments, both the structural reforms and Title III negotiations undertaken by the FOMB will collapse."

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

Francisco Rodríguez-Castro

President & CEO

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