Bondholders 'do possess perfected security interest' over property pledged by bankrupt public entity

THINK STRATEGICALLY:

La Jument, Jobs Growth Drive Markets

FOMC Leaves Rates Intact; U.S. Circuit Court: P.R. POBs Met 'Perfection Requirements,' Reverses District Court Order

BY FRANCISCO RODRÍGUEZ-CASTRO | frc@birlingcapital.com

La Jument, its history and markets

La Jument is the name of an impressive lighthouse in northwestern France, specifically Brittany. Built in 1911 on a rock known as La Jument about 30 meters off the coast of Ushant, this island marks the northwestern point of metropolitan France. France's west coast has always been known by sailors to be a rugged, dangerous and heavily trafficked sea lane, with severe weather much of the year.

The lighthouse became well-known in 1989, through a series of photographs taken by French photographer Jean Guichard. For this column, La Jument is used as a metaphor of how markets get rocky, volatile and, at times, may seem as if all is lost; however, if there are strong protection barriers, treacherous situations may be navigated. It is at this juncture that diversity and a trusted adviser are always key to preserving one's capital.

Job growth of 304,000 surpasses expectations

The U.S. Bureau of Labor Statistics reported total nonfarm payroll employment increased by 304,000 in January, the 100th month of increases to the U.S. workforce. The job numbers are also evidence of robust wage growth of 3 percent, compared with January 2018, which surprised most because the increase was able to brush off the impact of the partial federal government shutdown. However, when reviewing the 4.0 percent unemployment rate, which increased from December's 3.9 percent and was above last fall's 49-year low of 3.7 percent, the current unemployment number was expected to reflect the impact of the government shutdown. Digging deeper, it is noted that job gains occurred in several industries, including leisure, hospitality, construction, healthcare, transportation and warehousing.

Week in the markets: Equities rise at highest pace in 3 decades

As the first month of the year ended with 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 week at 25,063.89, a rise of 326.69, or 1.3 percent, and 7.4 percent year to date (YTD); the S&P 500 closed at 2,706.53, a gain of 41.77, or 1.6 percent, and 8.0 percent YTD. The Nasdaq closed at 7,164.15, an increase of 109.72, or 1.4 percent, and 9.5 percent YTD. Meanwhile, the U.S. Treasury's 10-year note dropped to 2.68 percent, or a yield decrease of minus-2.51 percent. The S&P 500 finished its strongest January since 1987, or 32 years ago.

The drivers of market growth were:

• Much stronger-than-expected earnings from corporations in every segment.

• The Federal Open Market Committee (FOMC) made a wise decision to keep interest rates untouched, as expected.

• The Federal Reserve Bank retracted its statement that pointed to further gradual rate increases, in part because of the global economic slowdown and indications of inflation pressures.

• A robust labor market and wage growth that can support continued consumer spending without driving a spike in inflation.

As the first month of the year ends, it is noted that during January, equities increased at the fastest pace in 32 years, with the DJIA rising to 7.4 percent YTD and up more than 14 percent from the market lows during the winter holiday season. Nonetheless, continue to expect slower growth and continued volatility.

The Federal Reserve Bank's firm grip on monetary policy may add volatility as the Federal Reserve adapts to current economic conditions, with less intervention expected regarding raising rates. Having said that, it is forecast that rates will rise slower than usual, with the yield curve remaining flat, as the current economic outlook for the U.S. economy is to grow at a modest 2.5 percent rate. Expect slower growth than last year, but at a steady enough pace to maintain the current bull market.

Final Word: Court reverses P.R. POBs ruling

When the Pension-Obligation Bonds (POBs) were structured, their income stream process was similar to the Sales Tax Financing Corp. (Cofina by its Spanish acronym), with all proceeds from government agencies' pension payments going directly toward paying the POB debt. The POBs provided liquidity to fund the pensions, and the government's strategy was to utilize the $3 billion and invest in the markets using several expert money managers to handle the strategy.

An example would be if the government had invested the funds in the DJIA in 2008. The $3 billion would have grown 327 percent to $9.81 billion. If it had invested in the S&P 500, it would have grown 3.06 percent to $9.18 billion. If it had invested in the Nasdaq, it would have grown 512 percent or $15.36 billion. As can be seen, the actual POB transaction was not flawed; what was faulty was the government' execution of its investment strategy, which left most proceeds in an account in the Government Development Bank that pays little or no interest.

Fast forward to the recent court decision affecting bondholders that own nearly $3 billion of debt issued by the Puerto Rico Employees Retirement System that have a claim on the pension funds.

The Financial Oversight & Management Board in July 2017 argued that bondholders' security interest on this debt was not accurately secured. Moreover, U.S. District Judge Laura Taylor Swain ruled that the bondholders "do not possess a perfected security interest" over property pledged by the bankrupt public entity to pay its debt.

In her opinion, she also said their claim over the pension system's revenue was "invalidated and unenforceable."

The U.S. Court of Appeals for the First Circuit determined that "bondholders met the requirements for perfection, beginning Dec. 17, 2015, and so reversed the district court."

As has been well-documented, the Government Employees Retirement System liquidated all its assets, and the government moved to pay-as-you-go programs, a system in which pension benefits are paid out of the general fund.

Since the story of the Pension-Obligation Bonds has not been adequately documented, an exclusive in-depth look at POBs will be dedicated toward dispelling many of the arguments that made them a political football.

Market Close Comparison

Market Close Comparison	1/25/19	2/1/19	Change
Dow Jones Industrial Average	24,737.20	25,063.89	1.32%
Standard & Poor's 500	2,664.76	2,706.53	1.57%
Nasdaq	7,164.86	7,263.87	1.38%
U.S. Treasury 10-Year Note	2.75%	2.68%	-2.51%

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