ECONOMY

Assess Your Asset Allocation

THINK STRATEGICALLY:

When Gov't Gets Drunk, Taxpayers Get the Hangover

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The Parade of Government Salary Hikes and Their Impact

Over the past few weeks, following the government plan of adjustment's approval, we have seen growing militancy among government employees—ranging from teachers and police officers, to firefighters and emergency workers—who are requesting sizable increases to their salaries. Before going any further, let me clarify my sincere wish is for government employees, as ranked in a meritocracy, to receive a bonus or salary increases.

However, it seems that government employees think that because the plan of adjustment was approved, Puerto Rico is no longer in bankruptcy, and that is far from the truth.

The most significant expense in most government agencies are payroll and benefits, often as much as 85 percent of some agency budgets, which leaves just 15 percent to other expenses and to offer their services.

So it is evident that by granting salary raises, the government is establishing new fixed costs while making additional promises, hoping to fulfill them once federal funds expire in two or three years. The gamble is that the new, incremental Medicaid funds could free up further general funds to pay these salary increase promises.

I have been requesting and reviewing information. While it would make some sense to grant one-time bonuses with the available federal funding, it does not appear financially prudent to phase in permanent pay increases in the hundreds of millions of dollars without a recurring funding source.

The recent salary increase for teachers is $340 million per year, which is double what was determined in the fiscal year 2024 budget. There was a zero salary increase budget for fiscal year 2022 and about $124 million for fiscal year 2023, and as you know, the salary increases were put into immediate effect.

What is the annual cost of a $1,000 monthly raise to all teachers? About $343.2 million (26,000 teachers, $1,000 monthly increase and fringe benefits ~10 percent). The first 10 percent goes into effect July 1 ($83 million), while the second 10 percent raise starts Jan. 1, 2022 ($41 million). The $470 monthly in fiscal year 2024 will represent $168.1 million.

However, it does not stop there; we must add to the parade of salary increases the raise for firefighters, correctional officers and emergency medical technicians. I suspect that the pay increase promises will not end there. All told, these hikes could add half a billion dollars, if not more, in fixed salary expenses for the Government of Puerto Rico. Can we afford that?

We must not forget that Puerto Rico is still technically in bankruptcy, and less than a month after approving the Financial Oversight and Management Board's plan of adjustment that erased close to 80 percent, or $50 billion, of bonded debt from Mainstreet to Wall Street.

For the past 30 years, the government has consistently overpromised and underdelivered. It has also implemented the practice of celebrating initiatives instead of results, and these actions constitute the very essence of imprudent financial management and are the reason we have the Puerto Rico Oversight, Management and Economic Stability Act (Promesa).

We must all cringe at the practice of making promises without recurring funding sources, which is what created Puerto Rico's fiscal crisis, ushering in Promesa and the Financial Oversight and Management Board. While we would all love to see government workers paid well, I think we must also implement a meritocratic system in all functions of the government.

In conclusion, all Puerto Ricans must be concerned with this current scenario of salary increases and other job-related promises. In the new opportunity Promesa and the plan of adjustment provided Puerto Rico, it requires our government to act with strict fiscal discipline.

More simply said, not spending more than the available revenue, not overpromising, stating the facts and sticking to the plan of adjustment to emerge from bankruptcy, as well as knowing how to avoid costly future mistakes. These salary increases paint a concerning issue.

The current scenario makes us remember that when the government gets drunk, taxpayers get the hangover.

The Week in Markets: Fear of war and inflation

All the indices we follow and most global markets registered the second consecutive losing week of 2022. The markets fear the probability of Russia invading Ukraine.

As it often occurs in these circumstances, there was increased volatility and a sell-off as investors took refuge in so-called safe-harbor asset classes.

With inflation being the No. 1 threat to the U.S. economy, the Federal Reserve is expected to raise interest rates as soon as March. We must add to the mix of market disruption the geopolitical tensions between the United States and Russia. In due time, the focus will shift from the fear of war to the economic and market fundamentals, expecting the markets to regain their footing with robust economic data and corporate earnings.

We strongly recommend that investors review their portfolios to position them for offense and defense in light of the rising volatility.

In addition to the threat of war, which impacts the markets in a very material manner, last week was options expiration day, which happens on the third Friday of each month. Trillions of dollars in options, futures on stocks, indexes and ETFs expire, causing the market to swing even further. The CBOE Volatility Index, known as VIX Index, rose to 27.75.

Weekly Market Close Comparison	2/18/2022	2/11/2022	Return	YTD
Dow Jones Industrial Average	34,079.18	34,738.06	-1.90%	-6.22%
Standard & Poor's 500	4,348.87	4,418.64	-1.58%	-8.76%
Nasdaq Composite	13,548.06	13,791.15	-1.76%	-13.40%
Birling Puerto Rico Stock Index	2,091.70	2,959.21	-29.32%	0.78%
U.S. Treasury 10-Year Note	1.92%	1.92%	0.00%	0.50%
U.S. Treasury 2-Year Note	1.47%	1.50%	-2.00%	0.50%

The Final Word: How Should Investors Position Themselves?

Wall Street has a history of looking beyond geopolitical conflicts, often focusing on the actual economic impact arising from any dispute. In this instance, the most likely scenario that could impact Europe if the Russia-Ukraine conflict escalates is that Russia provides 40 percent of Europe's natural gas consumption.

Seven pipelines and an eighth in construction supply Europe directly from Russia, so shutting these off could negatively impact Europe. Since the possibility of a conflict began, we have seen the WTI Crude price rise from $79.11 in November to close to $90, a 12.1 percent rise in two months. As the crisis develops, the United States considers lifting sanctions on Iran, a sizable oil producer.

Once the tensions subside, investors will again shift their attention to the economy, inflation and rising interest rates.

Three vital economic results were positive.

– U.S. Retail and Food Services Sales is at 3.75 percent, compared to -2.54 percent last month. The better than expected retail sales reflect a more willing than expected U.S. consumer.

– U.S. Producer Price Index fell to 9.65 percent, compared to 9.82 percent last month, the second drop after 10 months of increases.

– The Federal Open Market Committee minutes showed the Fed was ready to raise rates, but less aggressively than expected; up to 90 percent of the market had expected a 0.50 percent rate increase. Since the minutes' release, that number is now down to 33 percent.

We continue to see most states reopening and eliminating mask mandates, which will create robust economic growth. However, we need the coronavirus to remain contained.

Francisco Rodríguez-Castro is president and CEO of Birling Capital LLC. Think Strategically© is a publication by Birling Capital LLC that summarizes recent geopolitical, economic, market and other developments. This report is intended for general information purposes only and does not represent investment, legal, regulatory, or tax advice. Recipients are cautioned to seek appropriate professional counsel regarding any of the matters discussed.