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NASHVILLE NOTES

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POTUS and Bullard on real and fake debt relief

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In spite of reserve building for card portfolios at both JPMorgan Chase & Co. and Citigroup Inc., I do not think investors are too focused on credit, yet. Credit is cyclical; the tide is out presently and may stay out for a while after the 100-year flood of 2008. Credit investors appear to be more focused on the return on their capital rather than the return of it.

Not so with Puerto Rico. The question is how much will be returned whenever the bankruptcy process is concluded. President Trump weighed in on the subject in early October when he offered, "They owe a lot of money to your friends on Wall Street. We will have to wipe that out. I don't know if it is [Goldman Sachs Group Inc.], but whoever it is, you can wave goodbye to that."

There you have it. A real estate developer who has had several companies go bankrupt put in an opening bid to the lenders — zero. The next day various Puerto Rican debt issues that trade plummeted in price from already deeply distressed (or discounted!) prices. I doubt many Puerto Rico debt investors expected a shout-out from POTUS would be a catalyst to move the market.

Whether POTUS' comments were off the cuff or calculated, he stated the obvious: Wall Street loaned way too much money to Puerto Rico and its government way over-promised benefits to employees and citizens. The combined debt and pension obligations exceed $120 billion, which is a lot for an island with a not-especially-wealthy population of 3.4 million. The liability will climb with lost economic activity and the cost to rebuild as a result of Maria, unless the federal government completely picks up the out-of-pocket and opportunity costs.

Meredith Whitney was correct, too, in my opinion when in 2010 she predicted a wave of coming defaults among municipal issuers and perhaps some states. Regrettably, she violated a Wall Street rule of never predicting both how much *and* when during a December 2010 interview with 60 Minutes, as opposed to offering one or the other. The prediction, or unfair editing of her comments, produced a great buying opportunity in the muni market, as retail investors panicked and dumped bonds. Time will tell if buying Puerto Rican debt at around 33% of par following POTUS' comment was a great opportunity. Some predict that the restructure will leave creditors with just 10% to 20% of the original debt.

Contrast Puerto Rico's situation with the fake news that the finances of most developed countries, including the U.S., are tenable given the amount of debt and unfunded liabilities that continue to accumulate, absent some radical pick-up in the economy or negative actuarial change in our lifespans. When dealing with insurmountable debt throughout history, governments have faced two basic choices: inflate or default. Most go for inflation assuming they, unlike Puerto Rico, are a sovereign state that issues its own currency.

The Fed targeting 2% inflation, as opposed to 0% inflation, is another way to deal with too much debt by trying to ensure nominal growth is high enough to support debt service. I attended a breakfast in Memphis in January where St. Louis Fed President Jim Bullard spoke. I asked him why the Fed wants to haircut our money by 2% a year. To his credit, he offered that 0% or 1% might be the right number, but the Fed believes 2% is appropriate (as apparently do many central banks). He then quickly moved onto the next question.

Although the Fed is tip-toeing away from its zero-interest rate policy and bond buying by slowly hiking rates and reducing its balance sheet, Europe and Japan are mired in the surreal world of negative rates and massive asset buying. In other words, interest rates are subject to price controls as central bankers subsidize government finances with bond purchases and artificially low interest rates, while trying to stir inflation and economic growth with cheap money and asset inflation.

Whoever the new Fed chair is, I think it is false that our situation will not be as dire as Puerto Rico's position is now; however, I am not offering a prediction of when. That said, there will not be a default or debt jubilee because to do so would wipe out the banking system. Rather, I look for the government and Fed to push harder for inflation, even if it is not official policy.

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