Bond Case Briefs

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Munis For Dotards.

My friend John Mauldin is doing a great job beating the drum about the coming pension crisis (actually it has already arrived). The shortfalls in public and private pensions are staggering. Ben Bernanke and his colleagues at the Federal Reserve either didn't consider the effects of prolonged low interest rates on pension funds when they implemented their destructive policies a decade ago or didn't care or figured they had bigger problems to deal with, but the bill is coming due and cannot be paid.

The only question is how long states, cities and counties as well as the federal government can keep lying to people. According to a new report from the Pew Charitable Trusts, the shortfall in state pension and retiree healthcare benefits is now $1.1 trillion and $645 billion, respectively, based on 2015 data (the numbers are larger today). And remember, this comes nearly a decade into an epic bull market in stocks that lifted the value of the funds set aside to pay these benefits; imagine what will happen when the bull market ends (which, despite reports on CNBC to the contrary, will actually happen!).

New accounting rules require states and cities to book these obligations beginning in 2018, which will significantly weaken their financial statements and likely their credit ratings if the rating agencies are paying attention (something that is always questionable). According to Pew, states had only $48 billion in assets set aside in 2015 compared with $693 of retiree healthcare liabilities (though they do retain their taxing authority, though it is reaching its limit in many states). If you do the math, that's a mere 6.9% of the assets needed to pay these liabilities, which is both alarming and pathetic.

Municipal bond managers may have some serious explaining to do to their clients if this moribund but important market sells off as the true state of municipal finance is revealed. The municipal bond market is notoriously illiquid and opaque. It may turn out that Meredith Whitney wasn't wrong, just early in her warning a few years ago that munis aren't as safe as they seem.

Any asset class that offers virtually no upside and significant downside needs to be looked at with a jaundiced eye. Munis are one such asset class. Based on my three decades in the credit markets, it is clear that you don't need to be a rocket scientist to manage municipal bonds. Anyone paying someone more than a couple of basis points to manage munis is paying too much.

States and municipalities count on the limited capabilities and knowledge of municipal bond managers and buyers to fund themselves (and the municipal bond underwriting business is rife with corruption. But apparently even that low bar is too much for some muni managers who are wetting themselves in excitement over an upcoming bond offering by the hopelessly corrupt and insolvent state of Illinois, whose unpaid bills to vendors ballooned to a new all-time high of more than $16 billion (yes, that "billion" with a "b").

These managers are cheering an upcoming $6 billion Illinois General Obligation bond deal because a recent stop-gap two-year budget deal that kicked the can down the road to nowhere led to a short-term rally in Illinois municipal bonds. We all know about short memories in the financial markets, but the memories of municipal bond managers give fruit flies a run for their money.

These dotards should stretch their little minds and try to remember how hot and bothered they got when the similarly corrupt and insolvent territory of Puerto Rico sold 8% bonds due in 2035 at a discount (93 cents on the dollar) a few years ago. I warned readers away from those bonds at the time; hopefully you listened–they were trading at 51.75 cents on the dollar on September 27.

Just as Puerto Rico had no prospect of repaying those bonds (and defaulted on them and the rest of its $75 billion of debt), Illinois has no ability to repay this upcoming certificate of stupidity. Now, as Puerto Rico wrestles with the aftermath of Hurricane Maria, the island's bondholders are looking at even deeper losses as the board overseeing PROMESA (the acronym for the Puerto Rico Oversight, Management and Economic Stability Act that should be called NOPROMESA) decides if it can shift up to $1 billion of funds from bondholders to emergency rebuilding measures. What politician is going to vote against that?

Nonetheless, some of the most highly regarded names in the business (by the financial media, certainly not by me) are telling investors to run out and buy Illinois' debt (or more likely rationalizing why they intend to buy it for their clients). If you are a client of one of these firms, it is not too late for you to instruct them not to put this garbage in your account or to pull your money. Nuveen Investments' co-head of fixed income John Miller claims that the state has "turnaround potential." So does Zimbabwe.

Guy Davidson, director of municipal investments at AllianceBernstein, claims that the state has "stopped the bleeding. It's not like we think they have solved their problems. We just think they've stabilized their problems." Tell that to the vendors waiting for $16 billion of their bills to be paid (which will soon be $17 billion, then $18 billion–you get the picture). And Dennis Derby, a portfolio manager at Wells Fargo Asset Management, tells us that Illinois is "not under the gun as much as far as ratings go." That's because the gun is pointed at bondholders' heads and all of the chambers are loaded. Not to put too fine a point on it, but these comments should freak out anyone whose money is managed by these gentlemen and their firms.

Clearly the best and the brightest are not managing municipal bond portfolios and if any of these bright lights are managing yours and buy this new Illinois bond, you are in big trouble. Illinois' will be far from the last bankrupt municipality to sell worthless paper in the coming months and years and anyone incapable of avoiding this one is bound to throw more of your money down the rat hole if you give them a chance.

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