

or
ex

ASOCIACION PUERTORRIQUEÑA DE ANALISTAS FINANCIEROS



FINANCIAL PERSPECTIVES: 1987 AND BEYOND

A ROUNDTABLE WITH:



Raymond Stone

Chief Financial Economist,
Merrill Lynch, New York.
**U.S. Interest Rate Outlook
& Monetary Policy.**



Aaron Gurwitz

Vice President in charge
of Municipal Bond Research,
Salomon Brothers Inc., New York.
**U.S. Municipal-Tax
Exempt Market &
International Outlook.**



Miguel A. Ferrer

President of PaineWebber Inc.
of Puerto Rico
**Puerto Rico's Reactions
to Financial Market
Developments.**

Date: Thursday, January 29, 1987

Time: 5:30 PM

Place: Convention Room A, Caribe Hilton

Cost: Dinner - \$10.00 Members
- \$40.00 Non-members

RESERVATIONS: 758-1197

Visa and Master Charge will be honored. The activity will be in English.

Statement of Mr. Miguel A. Ferrer
Puerto Rico's Reaction to Financial Market Developments
January 29, 1987

Good Evening.

It gives me great pleasure to be here ^{Among} ~~with~~ such distinguished company discussing developments in the financial markets and their implications for Puerto Rico. I must say, however, that my inclusion in this panel to discuss economic matters, reminds me of a recent incident in which I greeted a local economist as "Señor Economista" and his response was "más economista eres tu", said with a certain distinct cynical tone. Whether he meant to exclude me from his profession or excuse himself for so being labeled, I did not seek to investigate. Nevertheless, I wouldn't go as far as Edmund Burke, the eighteenth century philosopher when he made the statement that "The age of chivalry is past. It has been succeeded by charlatans, economists and calculators. "The glory of Europe", he said, "is gone forever".

There are many ways of approaching the subject matter of this discussion. Certainly one can point to the continuing trends in lower interest rates as one major financial development. This

936 Changes

In winning this great battle Puerto Rico had to give up on certain benefits previously enjoyed.

The main results affecting our financial markets.

1) The passive income to operating income ratio is less generous than before, now 25% to 75% from 35% to 65%.

One of the generally practiced techniques to ease the ratio pressure was to invest in tax free municipals to produce interest income, which was excluded from gross income for these purposes.

The Alternative Minimum Tax, now provides a potential or real threat in that since municipal income is not counted as gross income, it is then subject to the AMT. Thus, in easing the ratio threat, one falls into more dangerous grounds.

Yet, if Puerto Rico could correct this definite peril to its own bonds by a technical correction in the just passed legislation it would accomplish a terrific demand for its bonds, they being then both tax exempt and outside of gross income, as well as a positive factor in reducing toll-gate taxes...

In the meantime, we sense that the shift from tax free to 2j investments will continue for 936 Corporations.

trend will probably continue, although not at the fast pace experienced in the past year. Another major financial development, which is hanging over us as the sword of Damocles is the continuing large budget deficits and the recent instability in the dollar.

How the Fed reacts to these developments will depend to a great extent on what the projections for the economy indicate. So far, and judging by last quarter's result, everything would indicate that monetary policy will continue as it has been for the recent past. This leaves US tax reform as the major external influence on financial markets in Puerto Rico.

For ease of discussion, I will address each area of change as relates to our local economy individually, making a parenthesis and warning you much of the ideas and concerns here discussed, arise from thoughts of different individuals..., who chose to be anonymous collaborators to this effort...

The not unexpected large repatriations that occurred in 1986 year end, to take advantage of past tax laws, reduced country exposure to many 936 Corporations.

It would seem that during this year and more definitely in 1988, we will see increasing accumulation of funds in our markets.

This year to some companies the ratio problem may pose a worrisome situation, but the year 1988 will then present the opposite, a wide margin of flexibility on passive income, versus operating income, since the running average of 3 years will be sharply reduced by the lower 1986 passive income level.

The lower cost of borrowing in the USA and the higher tax rates for corporations, I feel, will create an additional bias to keep funds in Puerto Rico, specially so, when our tax free rates and 936 rates are so attractive when compared with after tax Corporate borrowing costs.

MUNICIPAL AREA

a) Certain Puerto Rico bonds, which were previously sellable tax free, are now subject to US taxes, due to changes in Section #103 of the IRS code.

These cover AFICA, certain arbitrage bonds, certain refundings and affects public entities like PRIDCO, PRT. A major shift will occur in that these offerings will be targeted to the local marketplace.

b) Certain other bonds from Puerto Rico, which are not strictly public purpose, could be subject to Alternative Minimum Taxes in the USA.

These would need higher interest coupons to make them attractive. They would remain 100% tax free here.

Certain bonds issued in the US, subject to AMT will remain tax free here.

Since in these last cases the rates will need be higher, local investors will benefit.

As for the taxable Munis, these need to be studied carefully for they seem to produce tax free interest locally, although be subject to US taxation.

Therefore, to those whose projected incomes in the US allows them to pay the AMT and still benefit from the substantially higher rates the bonds offer, this newfangled muni bond merits attention.

THE NEW PUERTO RICO INDUSTRIAL INCENTIVES ACT

I firmly believe the new law has the nucleus for a powerful economic stimulus to our financial markets.

The incentives to invest long and invest at fixed rates will find its way into the regulations and help reduce the immense concentration of 936 funds in the very short end of the maturity spectrum.

Given the ability for 936 Corporations to swap investments without losing the benefits of the accrued holding period through the use of secondary markets, this will additionally bring forth the needed extra demand for longer term investments.

The real possibility that a liberalization of the definition of an eligible investment will occur, should greatly help to reduce overall rates and succeed in establishing a valid benchmark rate; a 936 prime rate.

This liberalization would have a very major effect across our marketplace.

I sense we shall feel these developments shortly and the corresponding market activity will be very beneficial to Puerto Rico, not to say to the financial community.

CAPITAL GAINS

The new sourcing rules basically state that in the sale of a financial asset, the transaction occurs in the residence of the seller. Thus all Puerto Rican residents will generate capital gains occurring in Puerto Rico and will be subject only to Puerto Rico capital gains, if the tax paid on these gains is 10% or more.

Since Puerto Rico has capital gains of 20% maximum, versus higher rates in the USA, there is a distinct advantage to our investors, individual and corporate.

The situation for Savings and Loan Association, which as you know are incorporated in the USA, eventhough they operate in Puerto Rico, seems to be resolved to the extent these generate 80% or more of their revenues from Puerto Rico sources. That being the case they would be deemed to be for these purposes as residing in Puerto Rico. Thus, capital gains subject to a 10% tax would be deemed to occur in Puerto Rico and would add to the 80% income being received from Puerto Rico sources.

This applies to securities sold, be they local or from outside Puerto Rico.

We see the of local institutions and very much so the Savings and Loan industry, increasing their trading activities to take advantage of gains, which would become Puerto Rico source income and be minimally taxed.

OUR OWN TAX REFORM

During 1985 and 1986 significant steps were taken in Puerto Rico to lower the tax impact on local tax payers and widen the tax base.

One law reduced the maximum individual income to 50%.

The secondary effect of this was to reduce the maximum tax on capital gains to 20%.

The law providing for the effective use of special partnership in Puerto Rico seems have begun having a salutatory effect in certain areas of the home building industry; while providing tax relief to those participants.

The new inheritance law has definitely brought a new dimension to local investments.

The tax on interest from certificates of deposits was reduced to 17% and the available deduction was increased to \$2,000. What this means is that \$33,000 investment in a CD at 6% is tax free. And, the tax to be paid on a \$50,000 CD at 7% is a \$255 or 7% tax rate.

These tax benefits, which are solely available for certificates of deposit and savings accounts, are said to have produced a great jump in the deposit base of our local banking institutions, about \$1 billion increase.

Candidly one must accept that the success of HACIENDA's drive to collect taxes owed on bearer certificates, obviously has also impacted this increase in footings, since much money outside of Puerto Rico availed itself of the sort-of-tax-amnesty offered.

But, the fact remains that by reducing taxes, savings have increased. A good lesson to keep in perspective.

On the other hand, the competing financial instruments have had correponding increases in their yields to maintain their competitiveness.

Local target tax free bonds need now to provide a rate at least equal to the after tax rate of the tax favored CD's.

This same situation has resulted in GNMA rates moving upward to remain competitive.

Therefore, a major investment opportunity presents itself to local investors seeking tax free instruments.

As dividends of local corporations are also tax advantaged to a 20% rate, the remaining investment vehicles need to be similarly treated to equalize our financial markets and not create imbalances between segments and to allow for the sorely needed development of active local corporate fixed income markets.

What is unusual is that the effect of having reduced the effective tax on CD's has not reduced the acceptable CD rates. Had this expected phenomenon occurred, the local cost of funds to the banking community would have been further reduced and the benefits to the local economy enhanced through passing the reduction in the cost of loans offered.

The question on why the expected did not happen would seem an interesting one to have answered.

Nevertheless, the law of gravity, I believe, will cause local taxable rates to come down, as soon as our income taxes are further reduced and real returns are taken into account. With the pent up supply of savings and investments funds, which will come about from the mainstreaming of the large underground economy these rates should stay relatively low and stable.

This being the case, I believe local target tax free products will also merit reduced rates and reflect good price increases.

What does this mean? That now is the time to bargain hunt. I mean right now, because local tax rates are already lower than last years and our financial markets are not fully reacting to this opportunity.

As our dynamic Secretary of the Treasury has pronounced in more than one forum, taxes will be down, and the law will be retroactive to January 1st, 1987.

With this good thought, I take the opportunity to say PAINWEBBER THANKS YOU and bid you good nite and good investing.

How will the Great Bull Market of the 1980s end? As we have stressed in this report, peering into the 1990s to answer that question is not so futile as it may appear, because history suggests that there have been only three major options: war, peacetime inflation or a financial panic. If the U.S. became involved in a major military conflict that lasted longer than 20 minutes, a long-term investment perspective would evaporate amidst high inflation, high taxes, and excruciating political uncertainty. Most investors would move their money out of stocks and into T-bills or commodities. In the past, this has actually proven to be a mistake, because wars are typically followed by bull markets that reflect four favorable trends: a return to low inflation, high wartime GNP growth that raises corporate earning power, resolution by the war of political obstacles (sectionalism in the 1850s, Nazism in the 1930s), and wartime breakthroughs of a technical or organizational nature (computers in World War II).

The second cause of bear turns in the stock market—peacetime inflation—is the most familiar one today but actually the least common. The Great Inflation of 1965-1980 is the only protracted period of peacetime inflation in U.S. history, and even that episode was ignited by the Vietnam War. Today's pervasive fear that rampant inflation will return nearly ensures that it will not; the first whiff of reflation will chase investors out of the bond market, sending interest rates skyward and precipitating a financial crisis in the heavily leveraged world economy.

Financial panic

This brings us to the third and most common cause of bear turns: a financial panic—a chain of bankruptcies in the financial markets and real economy that destroys confidence, decimates stock prices and typically ushers in a severe recession. The words "financial panic" strike fear into the heart of modern investors, who invariably identify it with the Great Depression of the 1930s. But this is a mistake. Of the seven panics that have caused prolonged bear markets, only two—the Panic of 1837 and the Crash of 1929—caused a collapse of the banking system and a decade-long depression. In both cases spectacularly misguided government policies contributed to the carnage. Attacking what he viewed as an aristocratic monopoly, Andrew Jackson killed the Bank of the United States, which was doing a creditable job of regulating the banking system, and a politically divided Federal Reserve permitted excessive speculation in the 1920s and a horrendous collapse of the money supply in the early thirties. For these reasons, as Chart 1 shows, the bear markets associated with these two panics were by far the worst in U.S. history; the panics of 1796, 1857, 1873, and 1892 were benign by comparison. One could argue that a brief panic and a two-year recession would be preferable to the 15 years of inflationary economic mismanagement that ended the last bull market.

Because neither a major war nor a peacetime inflation seems particularly likely, a simple process of elimination suggests that the current bull market will be ended by a financial panic. Moreover the preconditions for such a panic are being created by financial deregulation and innovation. Evidently forgetting the lessons of 1929, the Reagan Administration views deregulation of the financial markets as no different from deregulating the railroads or the airlines: the more competition and innovation, the better. Such reasoning lies behind the SEC's strong defense of junk bonds in the face of Federal Reserve efforts to regulate them. What the Administration is overlooking is that banks, brokers and insurers play a special fiduciary role in the economy because they function, in effect, as financial arteries. The energy panic of the 1980s devastated the economies of Texas, Oklahoma and Louisiana; a similar event in the financial markets would have much wider ramifications. For a foretaste of the future, investors could do worse than to examine the failure of Drysdale Securities; Penn Square Bank; Bevil, Bressler, and Schulman; and ESM Securities. In each case regulators failed until it was too late to curb reckless operations of questionable legality. In the future a likely trouble spot could well be aggressive S&Ls which can obtain deposits fairly cheaply, because they are insured by the FDIC, and use them to buy junk bonds or finance speculative real estate projects. For the S&Ls this is an attractive game of "heads I win; tails, Uncle Sam loses."

Dangers of innovation

Deregulation, computerization, and the high inflation of the 1970s have fostered a series of wide-ranging, interlocking innovations in the international financial system that will improve efficiency but also increase risk. Because the interest rates that banks and S&Ls can pay depositors have been deregulated, institutions may be forced to pay more for deposits and thus face pressure to book more risky loans. Mortgages, auto loans, commercial and industrial loans, and even loans to LDCs that used to remain on lenders' balance sheets have been transformed into marketable securities, such as mortgage-backed securities, commercial paper, and junk bonds. As the types of instruments have proliferated, the volume of trading has soared and a host of new hedging devices—options, futures, options on futures—have been invented. Firms have also invented new ways to borrow, such as home equity loans and credit card loans secured by stocks and bonds.

Like all innovations, the financial services revolution will yield surprises, some of them unpleasant. An 88-point single day decline in the DJIA—on a day when the economic news was positive—was not one of the benefits anticipated by the inventors of portfolio insurance. (They forgot to factor themselves into their computer simulations.) Moreover, many of

②

these innovations create new ways to borrow and lend—ways that appear attractive today precisely because they are too new to have been taken through a complete market cycle. Junk bonds are likely to negotiate the next recession about as well as conglomerates fared in the recessions of 1970 and 1974—very poorly. It is also significant that the shift to securitization severs the link between lender and borrower: when a bank or an S&L makes a loan, why should it pay great attention to credit quality if it intends to package and sell it to someone else?

Deregulation and innovation greatly intensify competition by eliminating the barriers between various classes of institutions. As commercial banks lose their top corporate borrowers to the commercial paper market and their mid-range borrowers to the junk bond market, they are transforming themselves into investment banks. Competition among financial service firms often takes the form of assuming bigger risks on behalf of their clients, whether by accepting smaller spreads on loans; accepting equity in a deal; or guaranteeing a loan. This form of competition inevitably drives firms to take bigger and bigger risks, just as money center banks competed aggressively to book loans at relatively small premiums to LIBOR during the 1970s. And it is the newcomers to the business—the firms with the least experience—that must take the biggest risks to get a piece of the action. In short, competitive pressures will compel financial service firms to assume large risks in developing credit structures that will be vulnerable to an unexpected shock.

The role of innovation in previous panics

Previous bull markets have also generated quite legitimate financial innovations that led to speculative excesses and, eventually, financial panics. During the 1790s a bull market in stocks, bonds, and enormous tracts of frontier land was fueled by a recent invention known as the commercial bank. Banks in New York, Philadelphia, and Baltimore lent freely to the politically powerful merchants who sat on their boards, allowing these speculators to acquire millions of acres of unsettled land in the Appalachian Mountains. When the expected flood of European settlers did not materialize and the land could not be sold, the speculators went bankrupt. On his way to debtors' prison the richest and most powerful of them all scribbled this note: "My money is gone, my furniture is to be sold, I am to go to prison and my family to starve, good night." During the bull market of the 1830s, state governments sold large bond issues to European investors in order to finance transportation projects that could compete with the hugely successful Erie Canal, completed in 1825. After the crash of 1836, no less than nine states defaulted on their bonds, and for a full decade European capitalists viewed Pennsylvania and Michigan with the same dread that they view Mexico and Bolivia today. The 1850s was the decade in which Wall Street became the center of railroad finance, as the modern investment banking house was invented. But ethical standards were not exalted, and well over half of the bonds that investment bankers under-

wrote during the boom defaulted after the panic of 1857. As for the great bull run of the 1920s, it spawned two notable innovations: multi-tier utility holding companies, of which the Insul empire was the most prominent, and highly leveraged closed-end mutual funds. These various innovations, not unlike financial futures and junk bonds today, made genuine improvements in the financial system but also created unforeseen risks and fostered excessive speculation that ultimately ended in a financial panic.

Stock index futures, for example, give speculators the same degree of leverage that aggressive margin trading offered in the 1920s. Speculators can control a block of stock with a cash outlay equal to just 7% of its market value, and the value of the underlying stock traded in the futures market often exceeds by a large margin the volume of trading in the cash market. Although futures prices normally track the values in the cash market, at critical moments the two may diverge, magnifying price swings in the cash market.

The trigger

What will trigger this panic? Quite possibly some unexpected bankruptcy during the next major recession. Unless the worldwide debt load is sharply reduced through economic growth or redistributed through enlightened economic policy, the "debt dominoes" in Mexico, the oil patch, commercial real estate, junk bond portfolios, and elsewhere could topple as cash flows shrink in an economic downturn. The panic would be accentuated by the increased use of speculative securities such as futures and junk debt. And confidence will erode all the faster if the Federal government is still running a large budget deficit, which would impair its ability to bail out failed banks and S&Ls without printing money and alarming the bond and currency markets.

A scenario

A hypothetical but plausible scenario might go like this: A recession causes big losses in the real estate and junk bond portfolios of certain go-go West Coast S&Ls. The resulting sell-off in the junk bond market causes heavy trading losses for several Wall Street firms, spreading alarm among foreign investors, much as the 1985 run on Ohio S&Ls did. The dollar declines sharply, foreigners lighten their Treasury bond portfolios, and as interest rates rise the junk bond debacle deepens. The bond market collapse also bankrupts a secondary player in the government bond market (in the same league as Drysdale Securities, Lombard Weil, and ESM Securities), causing sizable losses for municipalities and S&Ls that entered into repurchase agreements. As stock prices drop sharply, managers of "insured" index funds sell stock index futures, collapsing the futures premium and accelerating the sell-off in the cash market. Margin calls accelerate the wave of selling.

Meanwhile the FSLIC announces that it needs a \$30 billion infusion of funds to pay off the depositors of prostrate S&Ls. If the Fed comes to the rescue its credibility in international

credit markets will be jeopardized by investors' fear of a resurgence of inflation as Uncle Sam monetizes all the dubious loans generated by bankers over the past ten years. By this time, investor confidence has already been battered not only by the big drop in stocks, bonds, and the dollar, but also by the realization that higher interest rates and the approaching recession will greatly expand the Federal deficit. Personal finance columnists begin to discuss the shaky assets and off-balance-sheet liabilities of commercial banks and remind readers that the short-term paper of these banks stands behind their own shares in money market mutual funds, which are not government insured. Opting for safety over yield, thousands of investors redeem their money fund shares with a view to depositing the funds in a bank or (more wisely) T-bills. Fund managers scramble to dump the paper of suspect commercial banks, creating a liquidity squeeze.

All in all, a messy situation. It appears implausible today, but then so did the LDC debt crisis or the energy lending collapse in 1979. Although the panic might be sparked by an apparently random event, there is actually a fine historical symmetry in all of this. In the wake of the crash of 1929 and the Great Depression of the 1930s, Americans were keen on avoiding financial panics and violent deflations. Therefore the banks and brokers (like many other industries) were strictly regulated, and aggregate demand was sustained through generous fiscal and monetary stimulus. The long-term result was the Great Inflation of the 1970s. To break inflation Americans have accepted Paul Volcker's deflationary shock therapy and Ronald Reagan's program of aggressive deregulation. But in learning the lessons of the 1970s Americans seem to have forgotten the lessons of the 1930s, which they may be forced to learn again in what could become the panic of the 1990s.

When?

When will this panic happen? The question may well boil down to when the next *major* recession occurs. Forecasting the economic cycle over the long haul is impossible, but history is a useful guide. Since 1897 the length of time between the troughs of major recessions has been 7.6 years, and the longest interval (1958-1970) was 12 years. The low inflation and moderate economic growth of the current economic cycle—plus the Fed's realization that a recession could be financially hazardous—suggests that the current cycle will be relatively lengthy. Consequently a target date of 1990-1994 for the next turning point is plausible. If the turning point occurs sooner than 1990, this would be the shortest major bull market in U.S. history.

The signs to look for? Complacency. Bull market have always climbed a wall of worry, before falling off a cliff of complacency. The time to buy Treasury bills will be when the DJIA is much higher than it is today and a "new era" of limitless prosperity seems to be at hand—just as it was prior to the panic of 1836 (when the U.S. was swept by a boom in cotton and land prices that sparked breakneck settlement of the lower Mississippi Valley), the panic of 1857 (when recent

California gold discoveries invigorated the economy and encouraged a railroad boom linking the Midwest to the East Coast for the first time), and the crash of 1929 (when prosperity seemed so pervasive that a pillar of Wall Street wrote an article in *The Ladies Home Journal* judiciously titled "Everybody Ought to be Rich"). It is at precisely these times, when problems seem few and economic possibilities limitless, that greed overcomes fear and investors borrow recklessly to expand their positions.

Table 5

How high is high?

Profile of eight bull markets

	Length in years	Appreciation
1812-1836	23.7	+ 373%
1842-1854	12.0	+ 221
1859-1873	13.75	+ 323
1877-1892	15.4	+ 120
1896-1910	13.4	+ 155
1921-1929	8.1	+ 447
1950-1966	16.0	+ 393
1982-1986	4.1	+ 147*

*To peak price of \$1,919 '71

Clearly we are not at that point yet. Far from being self-satisfied, investors and politicians are wracked by self-doubt. Ronald Reagan has taken all the fun out of serving in Congress by making it a tedious tour of duty in an endless campaign to subdue the Federal deficit. Congress and the White House are so concerned about the waning competitiveness of the U.S. economy that they vanquished an army of lobbyists and rewrote the Federal tax code. Democratic Party chieftains are wondering how to shift the party's focus from redistributing income to improving U.S. competitiveness. Paul Volcker and James Baker were so alarmed by the U.S. trade deficit that they have convinced Japan and Western European radically to revalue their currencies. As for Wall Street, the speculative froth that usually crowns market peaks is nowhere to be seen. The broad market averages have backed off substantially from fears of low growth and inflation, and the relative multiples of emerging growth stocks are close to their historic lows. Despite shrinking returns from bonds, real estate, collectibles and commodities, individual investors have returned to stocks with caution.

The hope

The chances of avoiding a financial panic in the 1990s are very good if the Federal deficit is slashed significantly, solid economic growth over the next five years shrinks the overhang of private debt, and Federal regulators begin to worry seriously about the fundamental integrity of the financial system. One potential source of strong economic growth is a wild card—the "great wall of hope" that has tantalized the Western World for decades finally pays off. If the billions of people in India and the Peoples Republic of China continue to progress rapidly toward a "modern" consumer society, they will stimulate worldwide economic growth and postpone the next turning point.