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Cash for Clunkers…the State Version

It interests us when some government stimulus efforts are publicized heavily, while others stay out of the limelight. At Hamilton Point though, it is incumbent upon us to be aware of the obvious and esoteric when positioning investment portfolios. We hope readers of this letter will learn more about the subsidized state issuance of "Build America Bonds" — a federal stimulus that remains somewhat under the radar. We care about this because it demonstrates that our country's credit markets are still not fully functioning, and we must position portfolios accordingly.

TOO BIG BUT FLAILING

The government's well-publicized "Cash for Clunkers" program subsidized the purchase of new cars by offering an attractive cash incentive for trade-ins that were essentially pieces of junk. While on the surface, the program appeared to benefit carmakers' profits and the country's overall fuel efficiency, the government likely just pulled demand forward (meaning fewer cars sold in the future) and encouraged people to drive more in their new cars (thus negating the meager required fuel savings). In short, the government paid people to borrow money, in most cases, and buy today what they instead would have bought on their own over time.

In our view, too many government stimulus expenditures like "Clunkers" are well-intentioned, but short-sighted and fail to create real value—particularly when they subsidize activities that ought not be encouraged, such as incurring debt. By analogy, what if a parent paid off a spend-thrift child's credit card debt, only to demand "repayment" from a new program of paying for chores that the kid previously did for free? Sure, money would move around among the credit card company, the parent and the child, but the family's wealth would still be destroyed. Worse yet, what if the new program of now paying the little horror to take out the trash causes him to go out and take on even more debt—and demand payment for brushing his teeth!

THE MORE YOU BORROW, THE MORE YOU GET

Now, on to the related "stimulus" subject at hand which is state and local government issued Build America Bonds. Historically, states and municipalities financed their budgets in part by issuing tax-free municipal bonds which became the bedrock of the fixed-income portion of any highly-taxed investment portfolio.

When last year's financial meltdown arrived—complete with defaults on AAA-rated mortgage portfolios—investors took their fastest "flight to quality" in history. People started asking simple questions like, "*is there any scenario under which New York or California can pay off their debts without issuing increasing amounts of new debt, even though I am told they sport bond ratings of 'A' or better*?" The common sense answer is a resounding "*NO,*" unless investors rely on the state or municipality being deemed too big to fail—the safest of all havens these days.

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The crisis last year temporarily changed the game for municipal debt issuance. Some weak state governments had to issue debt during the crisis at a time when investors only wanted to buy Treasuries and things like Gold. But there were simply not enough highly-taxed individuals in the market to absorb so many new tax-free bonds at interest rates the debt-burdened states could afford to pay; so California had to issue I.O.U.s and Washington came to the rescue (again).

Deep within the stimulus package, was a cute subsidization trick—namely the Build America Bond program—which allowed state and local governments to issue *taxable* bonds at higher interest rates, thus attracting buyers like pension plans and foreign investors, while receiving a subsidy for the higher interest cost from the federal government. Naturally, the least fiscally-responsible state and local governments have the most to gain from this program, at the expense of *all* taxpayers.

For example, New York City recently issued $1.1 billion in bonds paying over 5.5%, but will receive cash from Washington equal to 35% of the cost—in this case a transfer (subsidy) from national taxpayers to New York City of $21 million annually. Altogether, transfer payments from this program will eventually total some $50 billion nationally—not bad pay, you might say, for brushing Wall Street's teeth.

I PRINT, YOU PRINT, AND WE ALL PRINT

When states issue and sell Build America Bonds that are ultimately bought by their own pension plans (with Federal subsidy to boot), we are reminded of what the Federal Government does when it prints money. The whole process smells funny to us, and therefore we do not recommend investors have a large portion of their fixed investments in any one state's municipal bonds if that government has shown an inability to manage persistent budgetary shortfalls without resorting to one-time subsidies and accounting tricks that borrow from the future. Put simply, their problems are not going away soon and no matter the increasingly meaningless debt rating, or supposed "insurance," few municipal bonds should be considered "dry powder" for liquidity purposes.

WHERE DOES HAMILTON POINT THESE DAYS?

The financial crisis has not really been fixed in our view. Our financial problems, like dark clouds, have slyly been moved from covering Wall Street to hanging over Washington D.C. in the form of deficits and ongoing guarantees.

We are puzzled by folks bidding up the shares of companies like Home Depot of late when, incongruously, the last place you will find these investors on Saturday is making a substantial purchase of a new grill or riding mower. It's as if the near zero short-term interest rates and excess liquidity produced by the Federal Reserve are encouraging purchases of corporate stocks and junk bonds but not those same companies' products in the form of revenues. This could be the Fed's equivalent to the "Cash for Clunkers" program, except that this time it is investors being encouraged to pay for the junk.

We still do see attractive value in selected global companies such as consumer staples, energy, agriculture, and numerous technology and industrial companies serving growing emerging markets. We also have fixed and alternative investments that should preserve capital well and protect against a declining dollar if the country ends up with more clunkers than cash at some point. Thank goodness for countries like China, India and Brazil who are chugging along, providing their citizens with better lifestyles and offering the developed world—including of course Hamilton Point's clients—investment opportunity.

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