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Lessons from Detroit

Even though financial reckoning was a long time coming for what was once the fourth largest city in the US, Detroit's bankruptcy filing in July was still a significant event in capital market history. For those who missed the news, on July 18th Motor City became the largest US municipality to ever file for protection from its creditors to whom it owes roughly $18 billion. The reasons for Detroit's misfortune are well-known and the ramifications are the subject of a titanic legal battle. Setting these aside, we believe there are a few lessons to be drawn from the bankruptcy – and they extend beyond the immediate impact on municipal bonds.

Municipal Bonds

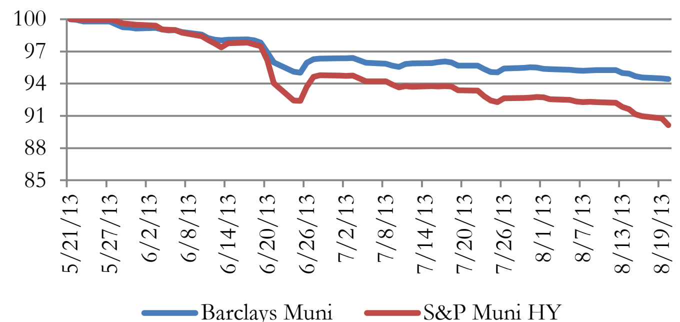
To begin the discussion, though, we consider the municipal market. Our long-held view is that credit risk, rather than interest rate risk, is more appropriate to take in bond markets right now (see our June *Investment Bulletin* for a thorough discussion of this topic). The average credit spread for an A-rated municipal bond was just 0.73% as of July 31st. Even if you adjust for the tax-exempt treatment of the income, there is not a whole lot in the deal for the credit risk. Instead, the returns for A to AAA municipal bonds are principally exposed to interest rate risk.

Here is why we are concerned. Ten-year AAA munis are trading at roughly the same yield as comparable treasuries, both near all-time lows. These bond yields have bounced off the lows over the last three months in a rapid sell-off (yields move inversely to price) that we make out to be the beginning of a longer-term trend. When you consider that the duration on the Barclays Municipal Bond Index is currently 8.4 (duration is an estimate of bond price depreciation per 1.0% interest rate increase), muni risk looks very worrisome.

Detroit bonds, of course, wouldn't have fallen in the AAA camp. It is worth considering if the high yield (below investment grade) corner of the market offers better value. Could compensation for credit risk make for an attractive investment opportunity?

We present Figure 1 to help get to that answer. First, it's important to separate out some of the noise that has driven all interest-rate sensitive instruments down since the Fed tapering discussion began on May 22nd. The two indexes presented – the Barclays Municipal Bond Index and S&P Municipal High Yield Index – have similar durations so it is reasonable to assume that interest rate increases impacted both equivalently. The difference between the drop in the blue and the red lines is therefore an approximation of how much the market penalized high yield munis for the credit risk. From May until August, they became about 4% cheaper relative to the broad muni universe. But are they cheap enough?

Figure 1: Detroit Aftermath
Cumulative Return (5/21/13 =100)
Source: Morningstar



Market upheaval leaves us with high yield munis yielding 6.9% versus 3.1% for the broad muni index today. Compare those figures to 6.1% for corporate high yields versus 3.2% for investment grade corporates. If you pay taxes at 40%, the tax-equivalent additional compensation for high yield munis is 6.3% (=(6.9%-3.1%)/(100%-40%)) versus 2.9% for corporates. When you also consider that municipal bonds have defaulted at a lower rate than similarly rated corporates, this math looks very tempting.

We, however, think this temptation reflects the increasing uncertainty in the muni market. The first lesson from Detroit is that the muni market has changed. Bondholders will increasingly be in competition with pension-holders for payments from cash-strapped municipalities. Just over half of the debt Detroit owes is in the form of unfunded obligations to its retired municipal workers. Credit risk on high yield munis is hard to assess because of the politically-charged nature of the competing bondholder and pensioner claims.

Debt & Demographics

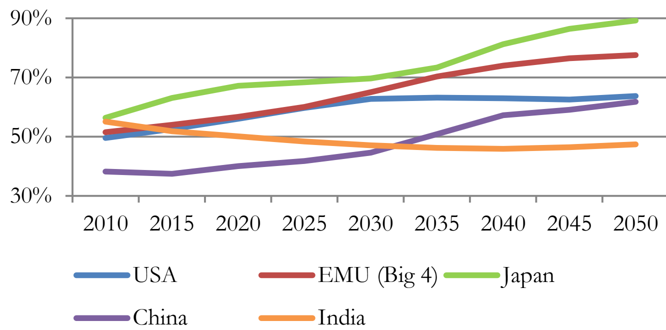
In our second quarter call-in, we mentioned that debt is an inconvenient topic which has been dropped from the public discourse this year. Luckily, the US still has the privilege of issuing the world's reserve currency which gives us cover for our short attention span for inconvenient topics. Down the road, though, it is clear that revenue generation and spending priorities need to be closer in size in order to keep the US on a sustainable fiscal trajectory.

The underlying problem is demographics. This is the second lesson from Detroit – a shrinking workforce cannot maintain the debts ac-

crued by larger workforces of the past. Motor City is certainly a drastic example. The city's population peaked at nearly 2 million in 1950 and subsequently more than halved to 700,000 by the time of the 2010 Census. The smaller tax base could not support the housing, infrastructure, and debt built up by their predecessors.

We extend this analysis to the macro level. Figure 2 plots World Bank's forecasted dependency ratios for some of the biggest countries/economic zones in the world. The dependency ratio measures the number of potential workers in an economy divided by the number of children (defined as under 15) and seniors who theoretically depend on the productive output of the working group. A ratio of 50% means two workers for every dependent; 100% means one worker per dependent. It is a somewhat of a crude measure, but still sheds some light on which countries might encounter Detroit-like problems in the future.

Figure 2: Forecasted Dependency Ratios
Dependency Ratio = (Population < 15 or > 65)/(Population 15 to 65)
Source: World Bank



The troubling picture is that the dependency ratio is predicted to deteriorate for most of the world's population centers. Japan and the Eurozone (proxied with data from Germany, France, Italy, and Spain) face the biggest demographic challenge, and unfortunately are starting out on the curve in a high debt-to-GDP ratio environment. China, albeit from a lower starting point, also faces a significant jump (2.5 workers per dependent slides to 1.5). The US is actually in pretty good shape while India is the only reviewed country that has a demographic tailwind in its favor.

This analysis colors our thinking in a number of ways. Stocks can be impacted by permanently lower earnings growth if work forces grow slowly (or shrink) without an offset from labor productivity. Further, a higher proportion of individuals in retirement mode combined with pension funds rebalancing to meet nearer-term obligations could reduce the multiple paid for those earnings. We think prices for all sorts of investments with a current pay will be bid up as alternatives to government bonds that will increasingly be issued to fund entitlements rather than the productivity boosting parts of the budget: education, research & development, and infrastructure. Deep trouble is far off, but the market will take into account incremental changes in the near-term.

Economic Diversification

The last lesson relates to how we think about efficiently deploying capital in those places we think are promising. What if Detroit was a country for which there was a dedicated index ETF available for purchase? As you might expect a holder of that ETF would be heavily exposed to the automotive industry. Using the number of local employees as a very rough proxy for the economic value produced in Motor City, we estimate the ETF would have $7 of exposure to Ford, $5 to GM, and $4 to Chrysler before getting $1 of exposure to anything else (DTE Energy). This suggests there would be ample opportunity to add value by uncovering interesting companies in other industries.

This is more than just a thought exercise. The economies in the developed world are pretty well diversified; it can be hard to add value especially when you consider fees, transaction costs, and taxes. We think this is the case for large US companies and recommend a cheap index-based approach to investing in the space. However, many emerging stock markets are concentrated in a few industries, notably petrochemicals, finance, and manufactured exports. We believe that passive exposure to the space could overexpose portfolios to these industries and companies. Actively managed funds, especially those with a mandate to capitalize on the consumer sector, are an attractive compliment and/or replacement. This is an important factor to consider when making investment decisions – we will return to it in a future *Investment Bulletin*.

The encouraging part of the Detroit bankruptcy is that the city may well have a chance to reinvent itself once the obligations racked up during years of decline are sorted out. This is possible because the sums are not overwhelming. At the macro level, the wealth involved is far larger. When constructing a portfolio, it pays to weigh how Motor City might impact municipal bond protection and might provide a blueprint for investing in environments of demographic decline and economic overconcentration. □

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