Vol. 10, Issue 25
Sept. 23, 2016

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

This week, I made a presentation to an estate planning group in Mobile. The speaker prior to me either wasn't aware of his allotted time or didn't care, as he went extremely long. So, I truncated my prepared remarks by about 10 minutes to keep the conference somewhat close to on schedule. No worries; when you make as many talks as I do, you learn to make adjustments on the fly.

Obviously, you can't adequately cover every aspect of the $19 trillion US economy, let alone future scenarios, in what had become a 35 minute presentation, okay, maybe 40. As a result, I had a number of people ask me questions during the break which followed my remarks. While most people wanted to talk about the upcoming election, two wanted to know my thoughts on unfunded public sector projected benefit (pension) obligations (PBOs), and their potential negative impact on Gross Domestic Product (GDP).

Really? 2?

Of all the many challenges facing the US economy over the next 3 decades, unfunded public sector PBOs are certainly one of them. I suppose your vocation determines the importance of a particular issue, and there were a fair number of CPAs in attendance. So, perhaps I shouldn't have been surprised by the interest. However, let me just say I don't normally get a lot of questions on the subject, let alone 2 in less than 5 minutes.

Let me give you a paraphrased amalgam of my discussions, and my comments come first:

> "You know, I am not certain if there is any consistency in the discount rates they are using to discount the present value of their future cash flows."
>
> "Well, the majority are undoubtedly discounting by the return assumption on the underlying assets, which is probably too high."
>
> "More than likely."
>
> "That would just serve to understate the PBOs. If they were using a realistic return or a spot on the yield curve, the number would be much higher and the unfunded status much greater."
>
> "Probably so. However, we are talking upwards of 30 years out, and a lot can change over that long of a time frame...from return assumptions to public entities freezing their plans. As I mentioned during my talk, the tables start to turn over around 2030 when more people turn 40 than turn 65."
>
> "You don't seem terribly worried about this."
>
> "I'm not. PBOs are as just that: projected. As long as the entity has the cash on hand to service the immediate payments, it isn't the problem the headlines make it out to be. They will just continue to kick the can down the road for as long as they can. You can think of it as a borrower continuing to service their debt even though they have broken a negative convenient on the loan. Do you call the loan or work with them?"

Inside this issue:

We cannot continue. Our pension costs and health care costs for our employees are going to bankrupt this city.
Michael Bloomberg

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"So, you don't think this will have a huge impact on GDP moving forward?"

"Let's just say the US economy isn't relying on public sector pensioners for its overall vibrancy, or lack thereof."

"So, you don't think some people will get hurt when, not if, public entities start reneging on their pension plans or cutting the promised payments?"

'That is not the question you originally asked. The answer to this one is 'most definitely.' However, our society isn't going to let a bunch of old people starve, let alone retired teachers, firefighters, and policemen."

I completely understand if you think I am being cavalier.

The truth is public entities will start freezing defined benefit plans and cashing out certain participants. This is exactly what the private sector has been doing for years. The math just doesn't work long-term, or at least not for the next 15 years. I mean there is no way every public pension plan will be able to meet every accrued liability, in full, and continue to offer the same benefits moving forward. No way, it isn't even close.

For long years, the accepted argument was public sector employees received ample benefits because they accepted a lower wage than what they could expect in the private sector. Currently, the starch to this argument isn't as strong as it once was, if there is any left at all, in aggregate.

According to the Bureau of Labor Statistics' (BLS) "May 2015 National Occupational Employment and Wage Estimates by Ownership," consider the following for the 00-0000 Occupation Code (All Occupations):

	Employment	Median Hourly Wage	Mean Hourly Wage	Annual Mean Salary
Federal , state and local government, including government owned schools and hospitals, and the US Post Office	21,385,650	$22.92	$26.02	$54,120
Cross Industry, private ownership only (private sector)	116,511,010	$16.42	$22.72	$47,250

To be sure, there are public employees who could indeed make more money in the private sector, if they so choose to enter the latter. I mean, an attorney at a high powered firm on the billable hour hamster wheel will certainly make more money than a public defender or a prosecutor in the DA's office. Depending on the firm and attorney, it might not even be close. The same could be said for medical specialists or any number of other professional occupations. The gap between public and private sector wages is particularly wide in information & technology, specifically for software designers. So, in some areas, yeah, there is a gap.

However, as the table shows, across all sectors, and that is really what we are worried about here, the average AND

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median public employee has a higher pay packet than the private sector employee. Hey, this is the government's own data. Please feel free to go to the following URLs to review (just cut & paste): **www.bls.gov/oes/current/999001.htm** and **www.bls.gov/oes/current/000001.htm**.

IF you choose to compare the data from these two sets, you should find a general rule of thumb: as the paygrade goes down, the average public sector employee does increasingly well relative to their private sector counterpart. Put another way, the 'government' pays (arguably) above market wages for 'unskilled' occupations and (arguably) below market wages for 'highly skilled' professions. There doesn't seem to be a significant difference, in aggregate, for those jobs in the middle….again, in aggregate.

The end result of the inevitable public pension reform won't be fun for someone, but it probably shouldn't send our economy reeling either. Further, when you amortize the underfunded status over the length of the time frame, it looks less daunting than the headline number. Even so, changes in the public sector pension business will happen, and not to the employees' great liking either, particularly those on the high end.

The practical end result for you, the taxpayer and citizen? In all likelihood, the quality of, say, public defending and prosecution will decrease over time, as the government will find it difficult to attract top talent for 'below market' wages **and** diminished benefits from this point. Higher taxes? That is intuitive, but getting folks to pay higher taxes simply to fund pension benefits will be a sticky wicket.

But this doesn't have much to do with the contemporary markets, does it? No.

This week's rally after what can only be called the Fed's inaction on Wednesday feels great. Folks are making money, and that is always a good thing. However, in the end, stock returns eventually come back to the same old boring thing: corporate profits. As you can imagine, there is a positive correlation between profits and economic growth. As such, if the economy isn't growing so fast/hot as to warrant an increase in the overnight lending target (to a still paltry 0.75%), you know, I don't think you can forecast a sudden, sharp spike in corporate profitability.

In fact, corporate profit growth has been hard to come by for the last several quarters, if not more. While there was a little uptick in EPS in the S&P 500 last quarter, overall, earnings in the index haven't done much of anything in the better part of 3 years. As such, this year's expansion in the Price/Earnings multiple has been a little surprising, all the more since the Federal Reserve seems to have a itchy trigger finger...at least from outward appearances. Historically, multiples don't accelerate during a tightening cycle. Perhaps this time WILL be different after all. If so, the only legitimate reason, if you can call it that, is there currently isn't another developed market with the same potential for ABSOLUTE return as the US.

Basically, US stocks are the contemporary financial equivalent of the old adage: "in the land of the blind, the one-eyed man is king."

For this nice rally to continue, US companies had better put up a fair number of positive earnings 'surprises' in the upcoming 3Q earnings releases. "It could have been worse," probably isn't going to cut it with investors this go around. That doesn't mean the markets will collapse a la 2008 or 2002; they shouldn't. It simply means it will be extremely difficult to hold onto September's somewhat surprising gains and multiple expansion with the Fed looming.

In so many words, profits have to catch up to the valuations before the Fed raises the target overnight lending rate, probably sometime before the end of March. We simply can't waltz into a rate hike with a P/E in excess of 20 with 2% GDP growth staring us straight in the face AND expect a double digit return from the stock market.

In the end, you don't have to be in a real hurry to either invest cash or do major surgery on your current portfolio….at least not at this time. I will have to get back with you after the earnings season gets underway. If the EPS of the S&P 500 dips back below 26, we will likely use that as an opportunity to rebalance accounts back to a more market neutral posture…..not freak out, just rebalance back to a more market neutral posture.

Take care, and have a great weekend.