

J. Michael Locke

Musings

#234: Musing August 5, 2023

Sorry for some of the typos and formatting issues in recent musings. The brains of the outfit – Jennifer Walsh – is out on maternity leave with her new son so my editing and publishing capabilities are significantly diminished. Bear with me.

I like the move by Fitch to downgrade US debt from AAA to AA+. Fitch is one of three credit rating agencies which evaluate the risk of an issuer paying back its debt. The US government has always been considered the safest issuer of all and all other types of debt generally trade on a “spread” to the rate on US debt to reflect the greater risk. The question is whether US debt is getting riskier. It is definitely getting out of control. This year there will be more outstanding debt than the GDP (it was only 65% of GDP just 12 years ago in 2011). Our gutless political class continues to cut taxes and increase spending. There will be a day of reckoning.

One way this reckoning might come is the pullback in those who buy all of this debt. Historically, other parts of our government (led by the Federal Reserve) were the biggest buyers in an intergovernmental shell game. After that it is foreign countries. That is right, we run up expenses in DC much greater than revenue and borrow from Japan and China to afford it.

Top 10 territories that own the most U.S. debt



Chart: Janet Nguyen/Marketplace • Source: [U.S. Treasury](#) • [Get the data](#)
• Created with [Datawrapper](#)

The huge fiscal expansion has also made the economy more immune from Fed rate increases. Interesting piece from Ray Dalio of Bridgewater fame. *“There was a big government-engineered shift in wealth from 1) the public sector (the central government and central bank) and 2) holders of government bonds to 3) the private sector (i.e., households and businesses). This made the private sector relatively insensitive to the Fed’s very rapid tightening to a more normal monetary policy. As a result of this coordinated government maneuver, the household sector’s balance sheets and income statements are in good shape, while the government’s are in bad shape. In the US and globally, the central governments’ balance sheets and income statements are bad and getting worse because the governments ran and are still running large deficits. They also have big losses on the government bonds they bought to fund the government debts and, with their balance sheets where they are, are losing money where interest rates are. Said more simply, central governments took on a lot more debt (so their balance sheets deteriorated) and central banks printed a lot more money (which caused inflation to rise) and bought a lot of the debt to get money into the hands of the private sector which, as a result, is now in relatively good shape financially.”*

Loans in corporate America to finance M&A are increasingly coming from non-banks. Many private equity firm themselves have created separate credit funds (I am not a fan of this with the PE firm having various positions across the capital structure and the inherent conflict). There are a ton of new entities lending including hedge funds and “Business Development Companies” or BDCs. Banks are at a disadvantage as they are regulated and forced to have more conservative balance sheets. Just last week, the regulators in DC proposed rules to increase the amount of money banks just have on standby (capital ratios) leading Jamie Dimon of JP Morgan Chase to complain that non-bank lenders were “dancing in the streets.”

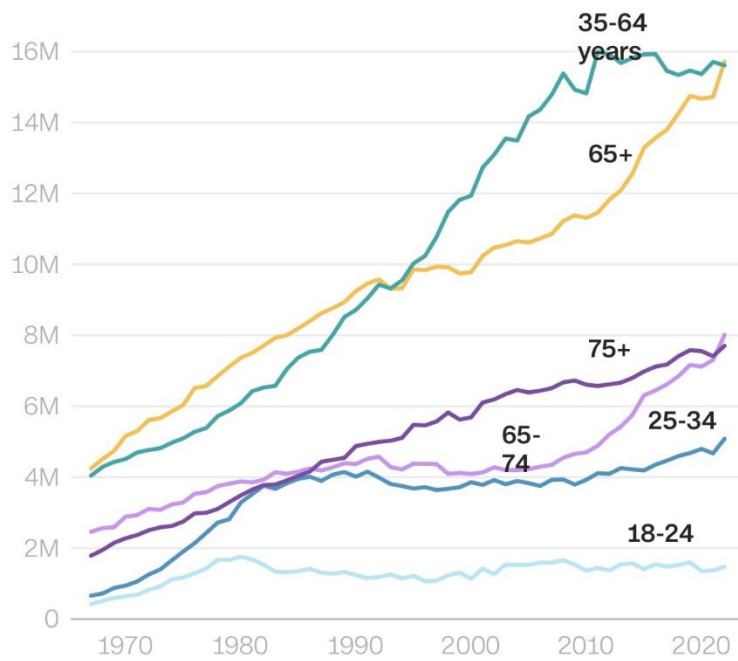
Look for more “structured” deals in the private world with higher rates and risk aversion. Rather than coming up with all of the money to buy all of the equity of a target, deals can be structured to reduce the buyer cash need. After the debt borrowed from a bank or BDC, the buyer can ask the seller to provide financing in a seller note (subordinated to the bank debt). The buyer might also connect some of the consideration to the future performance of the business in an “earn out”. Finally, the buyer might ask the seller to “roll over” and maintain a minority ownership position.

Negotiate an MFN clause in the pricing of your purchasing contracts if you ever have a chance. MFN stands for most favored nations and was created in the trade world. The idea is that you want the best pricing of what you are buying and if the seller ever gives someone a lower price, they have to come back and give you the lower price if you have an MFN clause. If you are a seller on the contract, NEVER give an MFN clause.

Interesting stat — Uber had collectively lost almost \$30 billion in operating losses from 2016 to Q1.

Unfortunately, more and more people find themselves living alone. Nearly 16 million people over 35 live by themselves in the US. Not sure what business opportunity this presents — a new form of senior living for healthy people with pickleball and sushi?

Number of people that live alone in each age group



Source: U.S Census Bureau's Current Population Survey, Annual Social and Economic Supplement
Graphic: Parker Leipzig, CNN



Jml