

Be cynical on government debt

Whilst I'm generally cynical about politicians, their creativity in finding ways to blame others for what are obviously their problems shows they do have intelligence, albeit in a Machiavellian way. Nancy Pelosi's recent [blaming of a hairdresser](#) for luring her into getting a haircut during her state's lockdown is a notable example. Whilst we can laugh about this for a haircut, it's a serious flaw for investors thinking about investing in government debt.

A recent example from California highlights the lengths politicians will go to on raising debt and spending money they wouldn't otherwise be allowed to. Two cities have [raised debt via a lease structure](#) using the literal streets of the cities as collateral. The lenders don't actually have rights to take over the streets in the event of non-payment. The use of a trust structure and leases is just a smoke and mirrors mechanism to bypass voters whose approval is legally required in certain circumstances. Whilst I can admire the creativity of the structuring, it's brazen behaviour that signals a willingness to do whatever it takes, legally or illegally, to achieve a desired political outcome.

This attitude becomes particularly problematic when governments find themselves in a financial hole. There's obvious benefits for a politician in blaming their predecessors and using a bankruptcy to cram down debts. Voters are likely to support these actions as they don't own the debt, faceless bondholders do. Compare this to a corporation where there's usually pain for the executives as their stock and options get wiped out in a bankruptcy. There's also a good chance the executives are fired as well.

Governments are all too often run on short term, vote winning strategies rather than long term investment principles. When you have flawed people, allocating other people's money with limited supervision it would be shocking if they spent prudently, rather than shocking that they are wasteful. Again, corporate executives that invest badly are likely to be fired but politicians regularly shrug off their failures.

All of this is a reminder that government debt is different from corporate and personal debt. It is typically far easier for those responsible to walk away from the problem without consequences. Those who hold government debt at bankruptcy often find they have little in the way of hard assets to foreclose upon and that they are effectively third ranking behind the provision of services and pension schemes. Add in the meagre returns offered on most government debt today and there's little reason for most investors to hold any of it in their portfolios.

Written by Jonathan Rochford for Narrow Road Capital on 12 September 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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