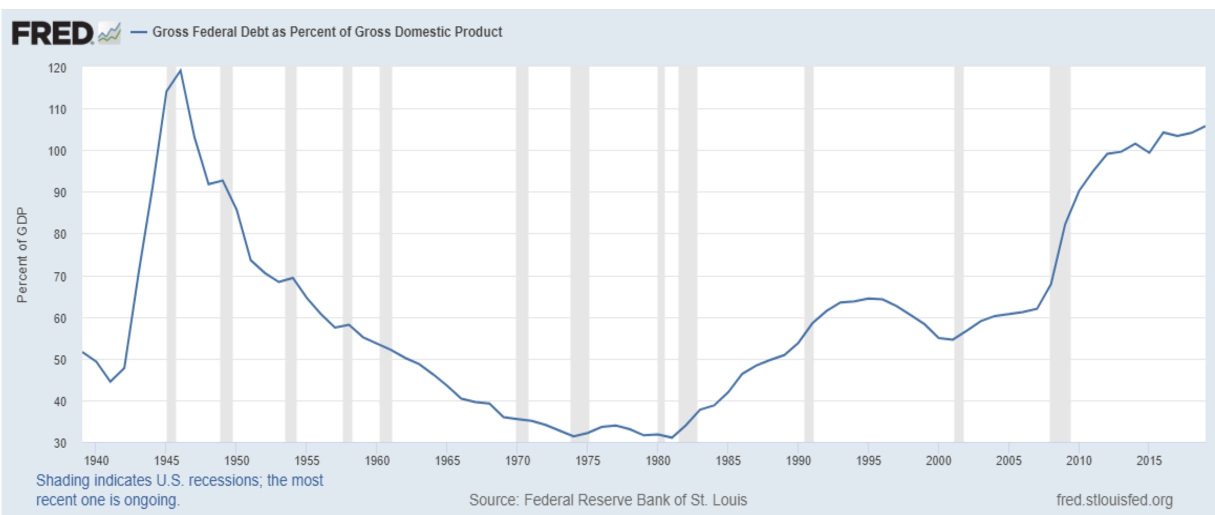
October 31, 2020

THE DEBT

How will the pandemic change our lives? This question is a constant topic of conversation from dinner tables to virtual board rooms. Sure, hygiene practices and technology use are obvious responses. Discussions surrounding the future of higher education, workplaces, travel, tourism, and hospitality offer more uncertainty and intellectual stimulation. Talk of politics carries high-risk and low reward, a turnoff for the investment mind. Still, the one subject certain to impact all of us—even more than a vaccine—remains elusive in popular discussions: the debt.

Ok, let us preface our commentary that we will not digress into fearmongering or an infomercial for gold. After all, it is the year 2020 so chances are that you have already been scared and/or bought gold all on your own accord.

To bring the subject into focus, the Congressional Budget Office (CBO) estimates that the Federal Budget Deficit will reach 16% of GDP in 2020, plumbing levels not seen since the depths of World War II. The IMF recently projected that gross global government debt will rise from 105% of GDP to 122% of GDP by the end of 2020. Turning more specifically to the U.S., estimates for U.S. gross federal debt to GDP are approximately 115% by the end of 2021, slightly below its level of 119% at the end of World War II.



Source: Federal Reserve Bank of St. Louis

In all fairness, the large rise in debt during 2020 represents a more legitimate emergency than bailing out reckless bankers in 2008-2009 and taken at face value the rise in U.S. gross public debt to the neighborhood of 115% remains navigable (but with conditions).

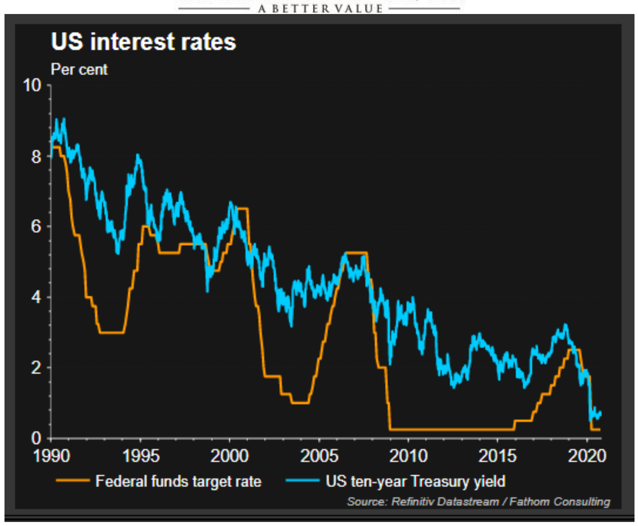
We mentioned before that the U.S. was similarly indebted in the wake of World War II. Specifically, the U.S. exited World War II with debt to GDP of 119% and by 1981 this figure had shrunk to 24.8%. A similar outcome is possible, but there are key differences between 2020 and 1946 that make it less likely. The tongue in cheek references to a "coronavirus baby boom" in the Spring of 2020 only draws our attention to the economic growth resulting from the *real* baby boom that transpired following WWII. This population growth and the resulting industrial ramp to service it followed by the baby-boomers entering the workforce helped propel economic growth and productivity for decades. This brings us to the paramount conclusion that economic growth is the *best* method to service and/or repay debt.

While baby-boomers helped propel the economic tailwind of that period their retirement may now be presenting a headwind (more on that later). Therefore, it seems more likely that the U.S. and other developed economies will rely on the second and third best methods to service and/or repay debt: higher inflation and higher tax rates. Although economic growth was critical in the post-war deleveraging process, steady inflation and rising tax rates were shadowy accomplices (i.e., from the 1950s-1970s the top tax rate was +70% and average inflation was 3.84%).

The problem we see is that the pandemic-fueled deficit and associated debt only pulled the inevitable spending and borrowing forward. Returning to the demographic headwind, in the U.S., 10,000 people turn age 65 every day as the baby-boomer population ages into retirement. Prior to the pandemic demographics were already fueling an acceleration in government spending on Social Security, Medicare, etc., which based on CBO estimates drives a forecasted debt to GDP of 142.2% by 2040. Should further fiscal stimulus materialize in the months to come, that forecast would need to increase.

The figures above should be eye-catching and even raise questions as to how the debt will be repaid. However, government debt is rarely ever repaid, but instead serviced and rolled over into perpetuity. If the debt cannot be serviced, then default occurs. To be readily understood government debt should be placed into the context of GDP, and it is when debt growth paces too far ahead of GDP that serviceability is affected. Conversely, when GDP grows faster than debt then the debt to GDP ratio shrinks over time (i.e., 1945-1980). In the present day, we do not believe that serviceability will become an issue, mostly thanks to the tight control that the Federal Reserve is exerting over interest rates. For example, while debt to GDP in the U.S. is currently twice its level from the year 2000, the U.S. government's interest expense as a percentage of GDP (3.1%) is nearly identical to its 2000 level. This statistical oddity results from the Federal Reserve holding interest rates aggressively low through its quantitative easing policy (currently purchasing $80 billion in treasuries per month).

In the following graph, we can see the one-dimensional path of falling interest rates for the past thirty years. At today's rates, only the 30-year Treasury with a yield of 1.68% successfully hurdles the September CPI growth of 1.4% from a year ago, meaning that all other issues are losing money in real-terms.



Sources: Refinitiv Datastream, Fathom Consulting

Building upon the last observation that the majority of the Treasury yield curve is generating a negative return in real terms, these circumstances are not by accident. In 2015 economists Carmen Reinhart and Belen Sbrancia wrote an IMF Working Paper titled "The Liquidation of Government Debt." Within the paper, the authors provide an analysis of the post-war deleveraging period we referenced earlier and based on their findings from 1945-1980 the U.S. spent approximately 50% of this period with negative real rates, and for that matter, the average real interest rate over the entire period was -0.3%. Given the deliberate manner that the U.S. government held rates below inflation during the 1945-1980 period, and the replication of this strategy today it is important to see this monetary policy for what it is, a confiscatory tax levied on savers. That represents an unfortunate development for savers and in particular the 10,000 or so people reaching retirement age with each passing day. The clear takeaway is that savers must guard against allocating too much wealth in bonds. It may feel safe, but unless monetary policy changes these savings will be steadily taxed away over time (through the loss of purchasing power).

If the concept of taxation through inflation and the loss of purchasing power seems abstract to some, the fiscal redress of high public debt through taxes on income is anything but. More often than not, policymakers attempt to repair large budget deficits and public debt levels through higher taxes on income and capital gains. Irrespective of the current election outcome it seems inevitable that taxation will be used to reduce the deficit spending and government debt burden.

Should the elections lead to new leadership, the markets have received at least an indication of contemplated tax policy changes. Prospective tax increases discussed to date are focused on U.S. corporations and high-income earners in the U.S. The discussed changes include increasing payroll taxes to 12.4% on earners above $400,000, restoring the top income tax bracket to 39.6%, taxing capital gains on earners above $1,000,000 at the 39.6% ordinary-income rate, increasing the corporate income tax from 21% to 28%, and creating an alternative minimum tax of at least 15% for corporations.

We believe from an investment perspective that these proposals unfortunately represent additional challenges to savings and wealth creation. Our focus relates to the prospective taxation of shareholder capital and the potential loss of growth as companies and the shareholders that own them lose the benefit of additional increases in: the rate of reinvestment (towards future growth), the growth rate of dividends, and the size of share repurchases.

Therein lies the problem with government debt. It is readily observable whether in the multi-decade case of Japan or the most indebted nations of the Eurozone that high total debt balances and lower economic growth show correlation. Several notable studies from economists point out similar relationships across the centuries. The basic summary is that the average growth rate in GDP for countries with a debt to GDP between 90%-120% is 2.4%, but when debt to GDP crosses 120% growth slips to 1.6%, on average.

In the modern cases of Japan and the EU—and increasingly in the U.S.—it appears that an acceleration of aging, demographics and, the accompanying marginal growth in the debt level alongside the loss of productive earned income (as workers retire) play some role in this waning growth dynamic. However, we believe these unique dynamics only complicate the conventional challenges to economic growth presented by debt levels approaching 120% of GDP. The conventional challenges to growth often cited from high government debt include the crowding out of private investment, aggressive taxation, and greater risk aversion towards capital investment. In our view, the economic policies and regulations that follow in the wake of a crisis and its accompanying spending and debt create obstacles to economic growth on a standalone basis.

If we take a step back for a moment and recount the aggressive monetary and fiscal policy changes that we have detailed in the past few pages it is easy to see that the economy and the capital that funds it has become significantly more regulated in less than one year. So, while demographic shifts present challenges to debt and fiscal matters, we struggle to cite fast-growing economies that are also heavily regulated. Moreover, once in place "emergency" regulations have a funny habit of sticking around. Taken in this light, as economic growth becomes challenged from the sudden increase in regulations (i.e., shelter orders, business shutdowns, travel limits/bans, rising safety standards, cross-border supply chain disruptions, financial repression on interest-bearing assets, and perhaps higher taxes on corporate profits and earned income, etc.) it is easier to see why the large ramp in debt will be difficult to pay down soon. This debt balance and the resulting policies represent to us an additional *weight* on society through the form of lower economic growth. In our view, the pandemic will run its course, but the accumulated debt and its economic impact could remain with us for much longer.

The good news, however (we believe) is that skillful capital allocation has the potential to derive a better outcome. This skill can be measured at both the shareholder and company level. First and foremost, investors (shareholders) must be flexible in their consideration of attractive growth opportunities across the global markets. If and when corporate tax rates increase in the U.S., shareholders in multinational and international firms could gain the advantage of lower tax jurisdictions and potentially higher growth rates in the return of capital to shareholders through the company's reinvestment into expansion, dividend growth, and/or share repurchases. Moreover, investors should remain focused on the firm's ability to grow capital internally as this increase in wealth is not taxed until gains become realized. It might be wise to consider the 39.6% ordinary income tax on dividends/capital gains for earners over $1M as an opening salvo. Now that is a scary thought for investors.

Thank you for following our commentaries and have a safe and happy Halloween!

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