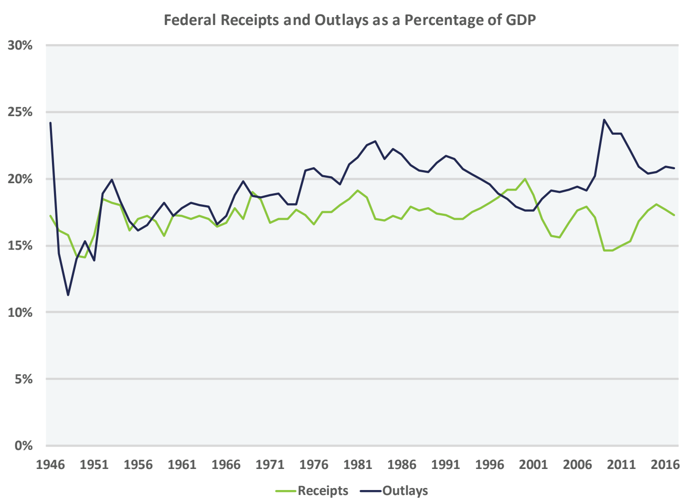
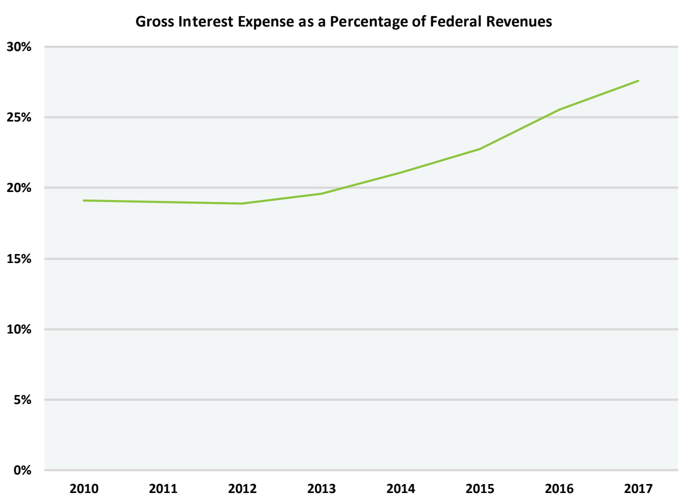
Deficits May Matter

Politicians and economists have long debated the economic impact of government deficits and the level of accumulated debt. Fiscal conservatives predict a debilitating resolution with a currency crisis, debt default and/or soaring inflation. Others argue the impact is minimized since the United States has the 'exorbitant privilege' of issuing the primary global reserve currency. 'We can print as much as we want' because the desirable U.S. Dollar still represents 65% of global currency reserves. Every trend comes to an end eventually and the final road is largely speculation. The simple part of the equation is the annual addition to our national debt = revenues less spending.





Federal revenues as a percent of GDP - the portion of annual economic output that goes to Washington - tends to fit in a relatively narrow range. Since 1946, the range has been 14 to 20%. Tax rates, allowable deductions, and tax credits have been massaged every 4 to 8 years with the objective of raising or lowering revenues. The results have not changed much and average 17.2% of GDP. Collectively, taxpayers manage to keep federal revenue relatively steady regardless of tax policies. Spending over the same period has varied more widely (from 12 to 24% of GDP) and has averaged 19.3% of GDP. The simple math is 17.2% minus 19.3% equals an annual 2.1% deficit on average. 2.1% sounds like a small number but the cumulative effect has taken the United States outstanding debt from 35% of GDP to 105% over the last 30 years. The practical impact for today is that interest costs are a rising component of the federal budget. Interest expense as a percent of revenue has increased from 19.1% in 2010 to 27.6% in 2017. Rising interest rates and a growing annual deficit will likely push this number higher in the near future. Deficits may matter.

Interest rates

The benchmark 10 year Treasury bond rate is 2.74%, exactly double the 1.37% low posted 21 months ago and 0.34% above the level of 3 months ago. The government is issuing more debt and the Federal Reserve is in the process of selling off its $4.5 Trillion bond portfolio. These two factors alone can explain lower bond prices and higher interest rates. Add in the potential for foreign sellers and it is hard to imagine rates moving significantly lower unless the economy is entering a period of weakness. Again, this is hard to imagine given the near term stimulus from lower tax rates and increased federal spending. We continue to feel the risk of owning longer-term bonds is not justified due to the potential of bond prices falling further.

The economy

Forecasts for economic growth have been bolstered by lower tax rates and higher government spending; however, consumer spending that is responsible for nearly 70% of economic activity indicates that consumers may not have jumped on the bandwagon yet. Retail sales for January and February are unchanged from the 4th quarter. Over the last 25 years, this statistic has ranged from -1.8 % during periods of economic weakness to 2.8% during periods of strength. The unchanged number indicates that consumers still may not be convinced the tax cuts will add to their disposable income or be permanent. Winter weather may have dampened spending and retail sales statistics will bear close watching over the next few months.

The stock market

Our year-end and February commentaries pointed out the increased level of risk and volatility in the equity markets as well as the expanded room for disappointment in the market leaders. Recent negative news for the social media business promises to be an inflection point as the prospect of government regulation looms. The European Union may require social media companies to offer an option for users to limit data sharing to a few basic data points. It is estimated that an account limited in this way would lose approximately half of its advertising revenue value. To the extent this requirement is imposed and adopted, values will fall. The 21% decline in Facebook shares may have already discounted a reduced value; however, the future regulatory environment is unknown at this time.

The corrections in social media stocks, the sharp 10% decline in equity prices from their January high, and the 90% losses in short volatility trades fit into the category of speculative excesses being removed from the markets. Yet, stock market averages were little changed for the first quarter. The S&P 500 total return was -0.76%, the Russell 2000 index of small companies was essentially unchanged and the Nasdaq composite gained 2.3%. The continued high level of stock market valuation does not predict a bear market, especially given bolstered prospects for corporate earnings growth. Elevated valuations and rising interest rates do portend larger declines and generally higher market volatility when bad news hits. However, stock market rallies tend to be larger as well. We will continue to let our sector valuation discipline guide our allocations to those segments of the market that offer the most attractive risk-adjusted return potential. Currently, we maintain a modest overweight in the health care and consumer staples sectors. These sectors possess relatively attractive risk adjusted growth prospects and have also been more resilient during recent market declines.

Thank you for your confidence in our firm as we continue to apply our disciplines to the markets, looking for opportunities to add value.

Your AAMA Team