Q1 2020 Market Commentary

As we begin a New Year and put 2019 behind us, we find ourselves coming off a market that proved to be resilient to various concerns about growth, yield curves and overall expectations. In order to forecast whether growth can continue, as we look forward to the next 12 months, we must understand what has gotten us to this point, economically and market wise.

Much of 2019's GDP growth was attributed to tax cuts, government spending and consumer spending. We anticipate that GDP will come in around 1.9 % for the year ahead, which isn't as robust as last year, but which is enough to avoid a recession. That said, current valuations in both stocks and bonds will create a headwind for the markets ability to greatly expand pricing of many different asset classes. Investors will be paying attention to earnings, despite rhetoric from the approaching election. Corporate spending on stock buybacks will diminish, reducing their impact on Price to Earnings ratios, and CFO's will continue to hoard cash to hedge against global trade uncertainties.

In short, we feel 2020 may be a more volatile year than 2019 as continued growth is already baked into market pricing. Examining the main drivers of that growth reveals that, should they falter, any and all have the potential to become the catalyst for a major disruption.

Consumer Spending, or Consumer Debt?

According to the Federal Reserve Bank of NY, household debt rose to $13.95 trillion dollars, which is an increase from the previous peak of $12.68 trillion, in 2008. With such low interest rates on mortgages over the past few years, we would expect this number to be high, given the ability of more people to enter home ownership on an affordable basis. On the other hand, Home Equity Loans (HELOCs) continue to decline in use since 2009, showing that Americans are less likely, at the moment, to tap home equity to support other spending. That is positive news.

What is troubling is a marked expansion in credit card and student loan debt. This has implications that are material to our economy because consumer spending still makes up nearly 70% of of total US GDP. Revolving credit (credit card debt) is notoriously expensive, and student loan debt can no longer be discharged in bankruptcy. These facts have an insidious effect on consumer spending.

The current amount of outstanding student loan debt, specifically, is worrisome on a number of levels. Since 2004, 90+ day delinquencies on student loans have nearly quadrupled, and defaults have more than quadrupled, showing a strain on the ability of some students to meet their obligations. As well, according to a study by TD Bank, the average graduating student spends roughly 20 % of their take home pay on student loan debt.

If consumers in their prime earning years are having a substantial portion of their take home pay being used for student loan repayment, it eliminates that cash flow for consumption of other items. Home ownership is a consequential example. While mortgages have increased due to low interest rates, according to a study done by Experian, 83 % of non-homeowners say that student loan debt is keeping them from buying a home.

While we don't want to get deep into the weeds of why the amount of student loan debt has increased (more students attending, too much capital made available, etc.) it's important to review in the context of its impact on consumer spending.

The same is true for credit card debt. According to NerdWallet, the average U.S. household has an estimated balance of $6,849 of revolving debt, an increase from the low of $4,679 in 2011 (according to TransUnion). Service on this debt is costing households an average of $1,162 in annual interest, which is more money that is unavailable for regular consumption. That is an average of $96 per month that might otherwise be spent in direct support of the economy … on groceries, for instance, or gasoline.

Obviously, things like mortgages, auto loans and even credit cards support various consumer industries and consumption. But non-consumptive spending, such as interest on revolving credit and student loan debt, are a drag on growth. While the argument can be made that higher education creates greater amounts of potential income through more highly skilled workers, when the cost takes 20 % of your take home pay, for 10+ years, that is a significant, and long-term, restraint on consumption.

According to the Federal Reserve Bank of NY, there are 44.7 million individuals in the US with student loan debt. And these are not all just new graduates, as this category of debt has been steadily increasing across all age groups.

Total Student Loan Balances by Age Group (in billions)

Source: Federal Reserve Bank of New York Consumer Credit Panel / Equifax

	under 30	**30-39**	**40-49**	**50-59**	**60+**
2004	147.8	112.3	48.7	29.5	6.3
2005	162.4	127.6	56.4	36.4	8.2
2006	196.3	154.8	69.8	48.2	12.2
2007	219.8	174.5	80.0	56.4	15.9
2008	250.9	205.4	94.4	67.6	20.4
2009	275.9	232.2	109.0	78.5	25.3
2010	301.2	261.2	128.5	89.6	30.8
2011	316.4	282.0	141.7	97.0	35.4
2012	322.7	320.2	167.3	111.3	43.0
2013	362.0	354.1	188.1	124.9	49.8
2014	370.5	383.1	207.6	136.5	57.7
2015	376.4	408.4	229.6	149.7	66.7
2016	383.2	437.4	255.6	163.2	76.3
2017	383.8	461.0	278.9	177.2	85.4

The average payment is $393 a month. That extrapolates out to $17,567,100,000 <u>a month</u> of payments. To put this in context, according to The Balance, the average US 30-year fixed mortgage payment is

$1,022 a month. If that student loan cash flow were able to be used for a home purchase that would equate to 17,188,943 potential homes being bought.

Household debt is something we want to keep an eye on. As household budgets become increasingly constrained by debt payments, we may expect to see HELOC balances increase again. Once those balances rise, the US consumer will again be tapped out and forced to reduce spending further. That would be a serious drag on GDP and a potential catalyst for recession

Government Spending (financed with debt)

According to the Federal Reserve Bank of St Louis (FRED), total US debt to GDP topped out at 105.46 % in Q3 2019. This represents a historic level and is only projected to grow further (to nearly 116% by 2024). Debt to GDP has been on the rise since the financial crisis, increasing at 5.8% annual pace from 64% in 2008, as the Federal Reserve bought billions of dollars in Treasury bonds to prop up a faltering financial system and then subsequently to bolster growth.

These quantitative easing actions have pushed interest rates to record low levels and for that reason the "cost" of US debt, relative to GDP, is just 1.89 %. That is nominally higher than the low of 1.62 % in 2012, but much lower than in 1994 when the rate was 5.04 % (the highest it had been since the 1970's).

It is important to understand that this rapid increase in debt over the past 12 years has resulted in an average 2.2 % annualized GDP over that time. That's a lot of fuel for very little fire, but that low, slow growth is also what makes the cost of our debt so affordable. Inflation has remained low at roughly 1.71%, preserving the value of the US dollar which is a direct benefit to consumers and debt-holders alike. That said, any increase in inflation would be negative for both.

So, there are two arguments to be made here. One is that sovereign debt is too high and unsustainable and the other that the level of sovereign debt is manageable based on its relative cost. There is also another, third argument that is gaining traction within political discussions about public debt and is being embraced (if not in words, then in action) by both parties – Modern Monetary Theory.

MMT suggests that, at the most basic level, sovereign debt doesn't matter as the US government never has to repay itself. This idea is more widespread than many think – even the Congressional Budget Office discounts Intragovernmental debt (the debt held by the Social Security Trust fund and the Military Pension fund, for instance) when it makes its forecasts. This is considered "non-public" debt and excluded from almost any analysis of US debt.

The problem is that the Intragovernmental debt will need to be paid, eventually. Social Security is the single largest owner of US public debt – it owns nearly 3 trillion dollars in Treasuries (almost 3 times what China owns) and if the total workforce continues to decrease while the number of retirees steadily increases, the Trust fund will inevitably need to "sell" that debt – to the public.

Right now, the US government is currently the most reliable bond issuer in the market, as evidenced by the current demand for Treasury bonds. This has been true for many decades, which is one reason why the US Dollar is the default, singular reserve currency for the world. But we cannot force anyone to buy our Treasury notes and if total US debt increases significantly from here, we risk being unable to convince the world to continue to buy Treasuries at a price that does not debase the US dollar.

That is how inflation starts, and as noted inflation would both increase the cost of our debt payments as well as reduce purchasing power for all consumers. Inflation is considered a leading indicator of an impending recession, which is why the market stumbles when interest rates rise too far, too fast.

Tax Cuts (financed with …)

That purchasing power got a boost in 2017 from the Tax Cuts and Jobs Act. Though there were many nuances, we want to focus on the simplification of the personal tax code and the overall reduction of tax rates, as it relates to both consumer and corporate spending.

Household income has been increasing steadily since the financial crisis along with GDP, but just as with GDP the increases have been low and slow, generally. There is no debate that most households saw a bigger bump in household income since the tax cuts, but the effects were decidedly uneven according to Census Bureau data.

	Lowest quintile	Second quintile	Middle quintile	Fourth quintile	Highest quintile	Top 5 percent
Avg Income in 2018	13,775	37,293	63,572	101,570	233,895	416,520
Increase since tax cut	3.9%	5.34%	3.26%	2.56%	5.43%	8.11%
Total Increase since 2008	18.18%	26.34%	26.81%	27.34%	36.74%	41.33%

Because of these general increases in income, personal tax receipts have increased from Q3 2018 to Q3 2019, according to FRED, offsetting revenue reductions from the tax cuts for the time being. However, this level of income increase must continue, without sparking inflation, to keep both the increases in government debt from accelerating and the cost of that debt from spiking.

We know that increases in personal income tend to have the greatest economic impact in the lower bands, as nearly every extra dollar received will be spent and disseminated through the larger economy. So far, the greatest increases have been in the higher bands, where extra funds tend to be saved more than spent. This suggests that the tax cuts have been even more beneficial to the stock market than they have been to the broader economy.

This is demonstrably true with regard to the cut in corporate taxes. Our reluctance to applaud the corporate tax cut stems from the actual use of that windfall. The premise for the cuts was that the funds would be used for reinvestment into the companies themselves and by extension the economy, thus spurring higher growth, higher wages and subsequently GDP. Yet, much of the funds have been used for corporate stock buybacks.

In 2018, there was record $800 billion of corporate buybacks in the S+P 500 and it is estimated that in 2019 we may have seen a trillion dollars of buybacks. While some of this capital naturally comes from the normal cash flow corporations have, much of the increase in stock buybacks is in direct response to the tax cut.

This was somewhat predictable, as corporations have been holding record levels of cash on their books for some time, and corporate tax receipts have been declining since 2016, falling from $326 billion in 2016 (9% of the total receipts) to $205 billion in 2019 (6% of total receipts), according to projections from the CBO. More of the same wasn't enough to compel many CFO's to do much more that invest in the stock market, although there were other, positive things done with the windfall as well.

Some companies used the excess cash flow to pay down or refinance their debt or shore up liabilities. As an example, FedEx bolstered their pension account by 2 billion dollars, which will help to keep that benefit in place for their employees. But again, those are non-consumptive expenditures, and we would have liked to have seen more being used for growth.

The decision to perform buybacks is the right of the Board and Senior Management in any company. They review the best use of the capital for the company and shareholders and many made the decision to buy back stock. While this has done great things for equity prices, it does little to promote actual GDP expansion.

For example, one of the largest S&P 500 components, whose stock rose by 42 % for 2019, had revenues in 2019 that were only 11.49 % better than 2018 and their profit margin remained flat. So, they sold 11.49 % more goods and services than the year before, but their stock rose 42 %. Why?

Because they reduced the number of outstanding shares by buying back over 2 % of their own stock, spending close to $2.1 billion dollars to do so, thus increasing the earnings per share by 20 %. Again, for the tax cut to be a more effective GDP growth engine, the savings need to be used for direct investment into the company via capital spending, R+D for new products or increasing payrolls. The corporate equivalent of buying a house.

The good news is that, because so little of the extra income from the corporate tax cuts has been spent on the real economy, GDP shouldn't be too deeply impacted when its effects – particularly stock buybacks – begin to fade. But a significant decrease in buybacks would be detrimental to the anticipated increase in shares prices, which is why we include the tax cuts as a potential source of disruption.

The buyback effect has helped to spur price appreciation that is well ahead of earnings increases – and those earnings increases will be harder and harder to come by unless capital spending picks up. It so happens that capital expenditures have been in a slump recently, increasing by just about 2% in 2019. In 2020, that increase is projected to shrink to 1% as uncertainty around trade, and other geopolitical issues, make real investment an even bigger risk for most companies.

This all comes at a time when investors are likely to be paying more attention to earnings, as noted, partly because of an awareness of the impacts that stock buybacks have had (and the impending dearth of more buybacks) and because price growth was so good in 2019 that it begs the question – can this continue?

The likely answer is no, and while that doesn't equate to a recession is does mean that further stock price appreciation will likely be choppy and, in certain areas, much less impressive in 2020. This makes our continued strategy of appropriate risk allocation all the more relevant. What the appropriate risk allocation means will be different from one person to the next, and so we urge clients to maintain their focus on their long-term planning goals and the structures that we have built to achieve them.

If you are concerned about meeting your goals, or the relevance of your portfolio structure, please don't hesitate to reach out to us to schedule a review, or simply to ask us any questions you may have.

Steven B Girard
President