Between the lines

Wealth Management
Dominion Securities

For the clients and friends of Ryan Chieduch

Winter 2020

The Chieduch Group of RBC Dominion Securities

chieduchgroup@rbc.com
905-895-5603 | 855-437-8784

www.chieduchgroup.com

Drowning in debt?

The U.S. national debt – which now exceeds $22 trillion and is expected to continue growing – is seen by some as a disaster waiting to happen. Right? Well, not exactly. Even though federal debt has soared relative to gross domestic product (GDP) in the past decade, the burden of the U.S. national debt is as low as it's ever been.

A falsehood that's too often repeated is that the national debt is over $22 trillion, but that figure is inflated, as it includes some $6 trillion that the government owes to itself, according to 2018 figures from the U.S. Government Accountability Office.

What's key to this debate is that the size of the debt relative to the economy is far less important than the level of interest rates. The true burden of debt is not the amount owed but the interest relative to GDP. Because interest rates are at historically low levels, the current burden of the U.S. national debt is as low as it has ever been.

Broadly speaking, debt is a zero-sum game. One person's debt is another's asset.

What will happen going forward? If the economy picks up steam, then money demand should decline, sentiment should improve, and interest rates should therefore rise. At the same time, a stronger economy would likely result in a further pickup in government revenues, a smaller deficit, and slower growth in federal debt. So rising interest rates should go hand in hand with slower growth in total debt, even as the burden of debt would tend to rise because of higher interest rates. This is not a recipe for disaster.

Looking ahead, I'm optimistic that the economy will continue to grow. I don't see a risk of recession in the near term. As always, I'll be watching the following indicators for signs of change.

Continued on page 2

Drowning in debt?
Continued from page 1

Monetary factors

Monetary policy and the stock market usually lead the economy by 6-9 months. In 2018, concerned by rapid growth and low unemployment, the Fed raised the discount rate four times in succession, (0.25% each time). Not surprisingly, the market corrected and in 2019, growth slowed. Reacting to the slowdown, in August 2019, the Fed lowered the discount rate by 0.25%, then did so again in September 2019. Those who understand the cause/effect relationship know well that growth is likely to improve in 2020.

Hence, until the Fed sees fit to tighten severely, choking off credit, a recession is unlikely.

Economic factors

One does not need a PhD in economics to understand the direction of the economy. As mentioned, monetary policy leads the economy by 6-9 months. While growth has slowed, easing last year is likely to result in improved growth in 2020. Also, keep in mind that the best environment for stocks is a period of modest growth and stable inflation, a condition that Federal Reserve Chair Jerome Powell is targeting. Last year, Powell said something to the effect of "we would like to smooth out the wild swings in past economic cycles by fine-tuning monetary policy." I believe that not enough attention has been paid to this statement. Powell has been putting these words into action.

Valuation factors

The current Price to Earnings ratio of the S&P 500 is 24.28, which means that the earnings yield on stocks is 4.12%, a premium of 2.32% over 10-year Treasuries. Investors are happy to pay $43 to be assured of an annual return of $1 in Treasuries, but it only takes $24 for the promise of $1 in equities. That is another way of measuring just how risk-averse this market is. Clearly, stocks are far more attractive than fixed income, especially compared to cash.

Sentiment factors

One of the most amazing aspects of this bull market is sentiment. It was 11 years ago that this great bull market began, yet not only is there no euphoria, investors, globally, are beyond pessimistic – they are downright fearful. The AAII Investor Sentiment Survey has become a widely followed measure of the mood of individual investors. The weekly survey results are published in financial publications including Barron's and Bloomberg, and are widely followed by market strategists, investment newsletter writers and other financial professionals. During the first week of January (after an incredible 2019) only 37.2% are feeling "bullish."

Supply/demand factors

From a timing standpoint, the supply/demand factors are imprecise, but typically, at major market tops, investors are heavily invested in equities and hold little cash, whereas at major market bottoms, they are very light on equities and sit on a mountain of cash.

This is another area that continues to amaze me. After 11 years in the bull market, coming off massive gains in 2019, investors are sitting on record cash and very light on equities. For 10 years or more, investors have been selling down their equity holdings. Presently, nearly $12 trillion are invested in negative yielding debt. Moreover, listings on the exchanges and net issuance of equities have been declining. Corporations have been buying back their shares, further shrinking the supply. Even a minor shift to the demand side will catch nearly everyone off guard.

Momentum/internal/ technical factors

Normally, when a bear market arrives, the Advance-Decline Lines peak 3-6 months before the major market averages. The latter being driven to new highs by the late-cycle sectors such as materials and energy. The Advance-Decline Lines are holding up near all-time highs. Momentum remains constructive.

In conclusion, none of the major factors suggest that this bull market is dying of old age.

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ® / ™ Trademark(s) of Royal Bank of Canada. Used under licence. © 2020 RBC Dominion Securities Inc. All rights reserved. 20_90407_JFS_001
(01/20)