Money Never Sleeps

The newsletter for the informed investor

Wealth Management
Dominion Securities

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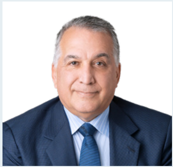

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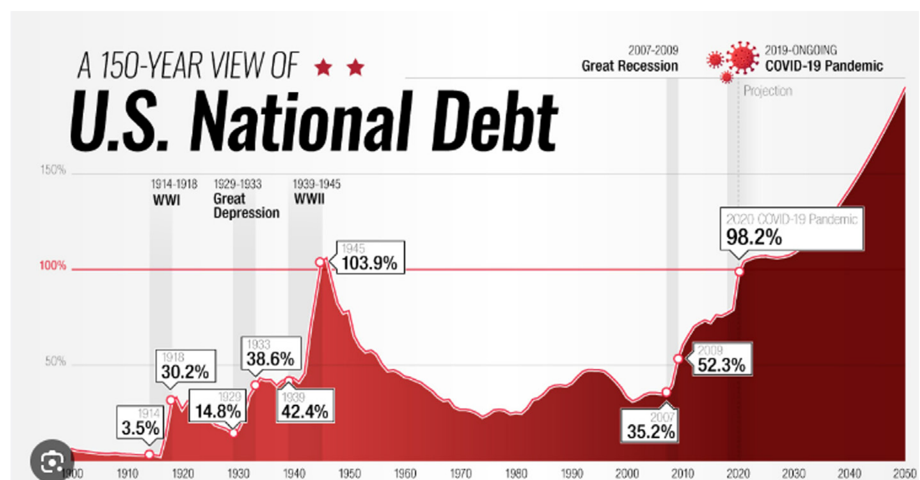
Dumping TINA for TARA

Is 2024 the year of "mights"?

"Governments never learn. Only people learn." – Milton Friedman

The U.S. government continues to spend much more than it receives in revenues. In 2023, it collected about $4.5 trillion in taxes, but spent $6.3 trillion. While the cost of servicing the nearly $35 trillion in debt is now over $1 trillion per year (or about 25% of all taxes collected), there doesn't seem to be any pause in sight. Non-defence spending by the U.S. federal government (including entitlements like Social Security) has climbed dramatically:

- 10% of gross domestic product (GDP) in 1960
- 14.8% of GDP in 2001
- 15.2% of GDP in 2007
- 17.8% of GDP in 2019
- And now, in 2024, it's projected to be at roughly 22% of GDP over the next five years
- Expected to peak at 27.7% in 2030



(Source: https://www.visualcapitalist.com/timeline-150-years-of-u-s-national-debt/)

In other words, non-defence spending now consumes more than twice as much of the GDP each year as it did 60 years ago. Government continues to take more and more of what the private sector produces.

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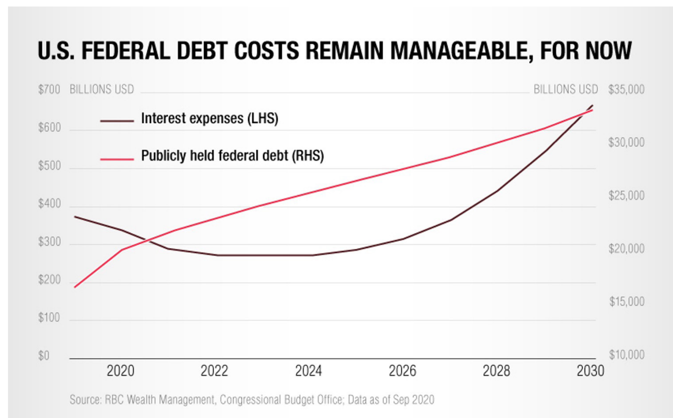

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It's not a revenue problem, it's a spending problem

What we have more of now is an economy that can only create slow, low-quality growth, and that, too, may stall out eventually. There are consequences to applying short-term solutions to serious problems instead of fixing the structural problems causing the issues. Don't believe me? Check out California, New York and Illinois and their budget problems, and the mass exodus of businesses and citizens happening out of those states.

For the past 15+ years since the Great Financial Crisis of 2008-09, rates around the globe have been virtually zero and, in many parts of the world, like Europe and Japan for instance, they were actually negative. In fact, it was just in the last couple weeks that Japan raised rates to "zero," making them the last sovereign on the planet with negative interest.

Central banks have artificially manipulated the yield curve, creating a lot of distortions. Aging investors, looking for some sort of yield on their savings, have been forced to assume a lot more risk, stretching for more yield than the money markets or Guaranteed Investment Certificates (GICs) could provide. So, into equities they poured, dividend paying stocks, bonds, and so on. They went because, at the time, they thought: "There Is No Alternative" (or TINA). They took on a lot more risk than usual because, as we know from the financial planning we do for clients, most people need at least 4% to 5% to continue on with what they'd like to do once they retire.

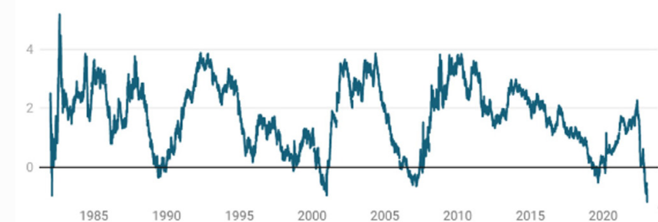
Post global lockdowns (surprise, surprise), inflation has exploded around the globe and central banks have had to raise rates to fulfill one of their mandates of price stability. Yet, inflation remains stubbornly high. In the meantime, investors have the ability to now lock in healthy returns on GIC and shorter-term deposits with minimal risk. This, in turn, also leads to a reduction in risk taking in the business community, also slowing down economic growth.

So now asset allocators can dump the "TINA" approach for "TARA" (There ARE Reasonable Alternatives).

While there seemed to be a consensus that recession was guaranteed in 2023, it hasn't happened, surprising many (including me). I still believe there are a couple of reasons for that:

1. There is a lag in monetary policy once implemented, and
2. The U.S. government (and others) injected so much stimulation and liquidity, and continues to do so, so rapidly, that the economy couldn't absorb it as quickly as in the past, and still hasn't absorbed it as they continue to add every week / month.

The bond market, which has had its longest inversion in history, has been telling us that since October 2022, when the three-month U.S. treasury yield rose above the 10-year yield. Historically, this "inverted yield curve" signals that the U.S. Federal Reserve (the Fed) is tight and recession odds rising. An inverted yield curve doesn't guarantee a recession, but one has never happened in market history without an inverted yield curve.



(Source: Forbes https://www.forbes.com/sites/simonmoore/2023/01/09/yield-curve-inverts-to-historic-lows-sounding-recession-warning/?sh=32deb439422e)

For the last while, the market has ignored the yield curve. It doesn't seem to mean what it once did. Longer term bond yields are more affected by what investors think the Fed will do with rates, rather than how that might impact the economic trends. The Fed has held interest rates below inflation for roughly 80% of the time since 2009, leading to distortions in markets, the banking system, and increased risk taking by investors (i.e. crypto, "meme stocks", NFTs just to name a few).

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The problem will arise when short term rates, which have been rising once again, make it so the repo market the Fed has been using to prop things up stops working. The repo market is made up of short-term loans. Banks use those repo loans to arbitrage in the U.S. treasury market and make spread profits. When rates rise, the arbitrage stops working.

At that point, banks will be stuck with U.S. treasuries paying a relatively low rate (say 3%), and losing value as rates continue to rise, even if only slightly higher, like say 3.05%. The banks will lose money. If they borrowed to perform the arbitrage, they're stuck paying higher rates for that period while receiving a lower rate in return. It's the risk of borrowing at a variable rate while loaning at fixed rate. Liquidity will dry up. DOH! It's basically what happened to the U.S. regional banks last spring, leading to the default of a couple of big names in the space. The longer the charade goes on, the more cautious participants in the system get.

If the "tipping point" is reached, the Fed will be forced to buy securities to maintain the interest rate ceiling it desires, similar to what it did in 2019 when the repo market went wacky at that time. It's the only way for embarrassed bureaucrats to regain control over interest rates. Japan did it for decades, even owning equities in the Japanese market.

Besides the elephant in the room of the massive U.S. debt, the second item that becomes an issue in 2024 is the Fed's timing. This year is a Presidential election year, and typically the Fed sits on its hands most election years, so as to not have the optics of favouritism. So, if the Fed is going to cut, the timing and the optics of those cuts now becomes an issue. Our favourite economist, Milton Friedman, taught us that monetary policy has a lag of 8 to 13 months. So the reality is, the impact of any interest rate cuts will really start benefitting things in 2025. In other words, Jerome Powell and his band are going to juice the economy in the middle of a hotly contested election, and the benefit will only come in the middle of 2025, long after the election is over?

When has the Fed raised rates in a Presidential election year you may ask? Well, since 1994:

- 1996: Cut once in January by .25 basis point. Done for the rest of the year.
- 2008: Cut from 4% to zero in response to the Global Financial Crisis
- 2020: Drove rates to zero by February in response to the COVID-19 pandemic

So, in the past 30 years, cuts in Presidential election years have come mainly because everything was "hitting the fan," and the Fed was forced to act. With the soft landing they claim we are experiencing, what's the incentive for multiple rate cuts in an election year?

Donald Trump has already publicly stated that he is going to replace Powell if elected. Don't be surprised if Powell, the human being, is susceptible to incentive-driven performance like everyone else. The Fed has illustrated repeatedly that they are neither politically independent nor data dependent (or rate cuts wouldn't even be being discussed with the current GDP, job numbers or inflation rates).

Less than a month after he was reappointed after his first term, Powell raised interest rates +.075 basis points, after promising a rate hike was "off the table." He then proceeded to deliver four rate hikes in a row. There is a good chance that the Fed is setting itself up to repeat the policy mistakes of the 1970s, when it was on the brink of success then, the Fed bowed to political pressure, fired up the printing presses and inflation ramped back up.

Now, four months into 2024, we have a bunch of "mights" on the table. All of which have a reasonable probability that they could happen. We "might" have a soft landing. We "might" get a recession. We "might" get a credit crisis. We "might" get a serious correction. We "might" get an expanded war. We "might" get political turmoil. We "might" get $100 oil prices. We "might" get another ramp up of inflation. We "might" not even get a pullback at all in 2024, and markets ramp up all year long into the election from all the stimulus (i.e. spending) being applied.

I do know that the Fed and the Biden administration are adding liquidity in a large way still. We are getting monetary stimulus, we're getting fiscal stimulus, and economic activity is predicated and perhaps has even accelerated under an inflationary psychology. But thanks to "TARA," investors have more options now.

The bottom line is, most federal government spending is way too high, it's unsustainable, and most politicians simply do not seem to care. It creates a slow decay that even new technologies raising productivity cannot overcome because that "big government" and its policies act like a ball and chain on those gains.

This government spending isn't lifting longer-term growth, it's actually stealing from future growth and our kids and grandkids, but most haven't caught on yet – but they will.

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