WELLS TRECASO
FINANCIAL GROUP

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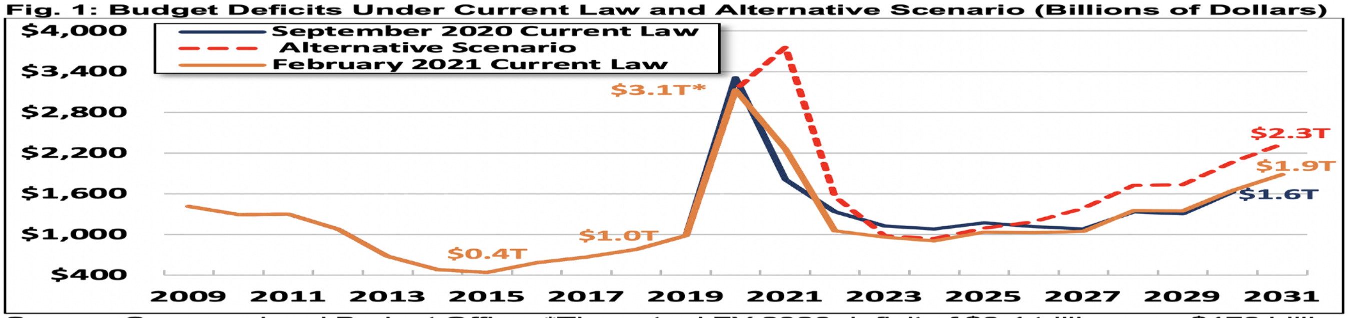
Portfolio Talk

Market Update 03/05/2021

After the House passed the $1.9 trillion COVID relief bill, the Senate gets ready to make it official. Many worry that the growing deficit caused by the increased spending could cause our national debt to become unserviceable in the near future. Those that argue against this being a problem say that since borrowing costs (interest rates) are so cheap, why not make the package too big vs. too small, we'll deal with the debt afterwards. This thought process actually makes sense theoretically, but there's one problem, the government does not work that way. So, as the chart below indicates, with the increased spending our national deficit in 2020 & 2021 will grow to just north of $3 trillion in each year. Without the relief, 2021 was projected to come in at $2.1 trillion.

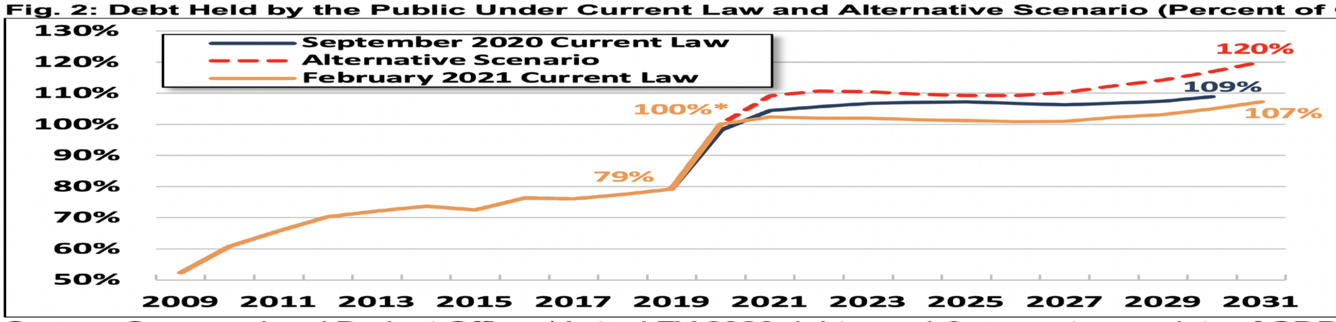
Fig. 1: Budget Deficits Under Current Law and Alternative Scenario (Billions of Dollars)



Source: Congressional Budget Office. *The actual FY 2020 deficit of $3.1 trillion was $179 billion lower than the $3.3 trillion deficit CBO projected in its September 2020 baseline.

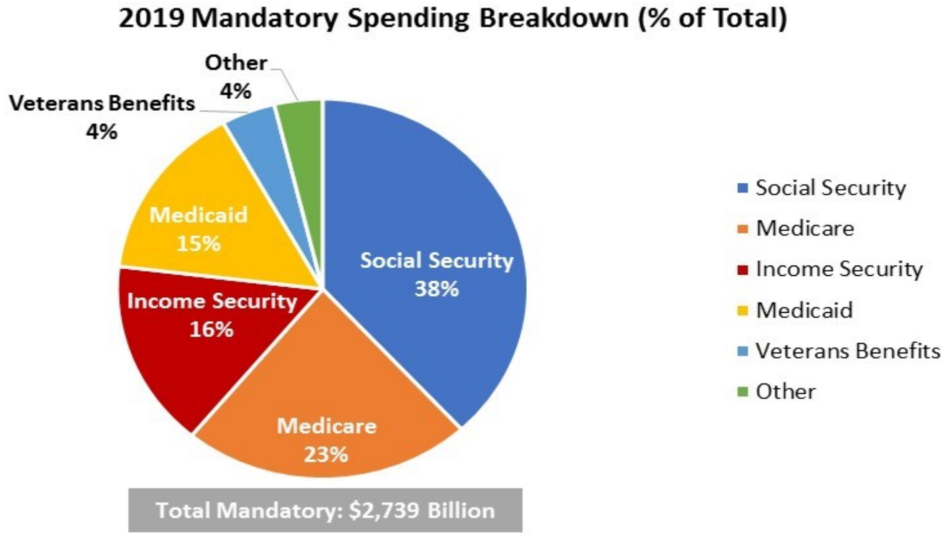
All in this takes our national debt to approximately $26-27 trillion by the end of 2021. Our US Gross Domestic Product (GDP) is forecast to grow to around $21 trillion by the end of 2021. We were projected to end 2021 with a debt to GDP ratio of 115%. Adding the 2021 deficit to our current debt now puts the ratio at 140-150%, the highest level we have seen since WWII.

Fig. 2: Debt Held by the Public Under Current Law and Alternative Scenario (Percent of GDP)



Source: Congressional Budget Office. *Actual FY 2020 debt was 1.9 percentage points of GDP higher than the 98.2 percent CBO projected in its September 2020 baseline.

The question remains, can we service the debt by paying the interest and principle when the debt comes due? First let's take a look at the 2019's Federal Government Mandated spending breakdown.



Source-US Office of Management & Budget:

These expenses are those that the government is required to spend. Programs such as Social Security and Medicare are approximately 61 cents of every tax dollar collected. Not only that, but the cost of carrying the debt is not even considered in mandated spending and that was an additional $375 billion in 2019, or approximately 12%. Now comes the part that concerns most economists, if our debt grows to $27 trillion and the cost of borrowing goes up by 1%, that's an additional $270 billion of carry cost of which we get zero benefit from. What's worse, what if rates go up by 2%? This would still represent a historically low rate environment and these are funds taken away from balancing the budget long term. It's a rabbit hole that's deep and chances of recovery become slim without taking draconian measures to correct. Items like Social Security and Medicare having to be cut for the elderly, something no politician will touch until they have to.

So, if cutting spending has a low probability, what other options do we have? How about looking at the tax code? One new tax offered this week by Senator Elizabeth Warren was the "Wealth Tax". The tag line, it's just 2 cents on each dollar above $50,000,000 and 3 cents on those above $1 billion. Would this be enough to offset the growing deficit? Let's look at the numbers: There are approximately 97,287 households with net worth's equal to or greater than $50,000,000 as of September 30, 2020. Of those, there are 34,507 that have net worth greater than $100,000,000. Those that argue against the tax say that there's just not enough households that would pay enough in taxes to make a dent in the deficit. They further state that there are several problems with implementing a wealth tax. First and foremost is the fact that almost every country that's tried a wealth tax have done away with it. Why? Their high net worth citizens have either given up their citizenship or transferred/hidden their wealth. Secondly, most households with high net worth's own businesses or hard assets; land, farms, buildings, etc. A wealth tax either requires them to sell or borrow against their assets to cover the tax. The first year, they state, doesn't seem to be a problem, but as the years accumulate so does the selling or borrowing. The eventual affect becomes regressive possibly effecting job growth, research and development, and leading us down a path that Europe walked away from 30 years ago.

So, why are these important issues we need to consider? The stock market tends to be a leading indicator of economic and political event in the future. Whatever effects corporate earnings are felt, either positively or negatively, months ahead of their actual reporting. A growing deficit and national debt are seen as inflationary. Higher inflation usually leads to higher interest rates, and higher interest rates may lead to lower price/earnings ratios (P/E's). It's important to understand this relationship when allocating assets as an investor so you can diversify portfolios and manage risks. We are in a rising interest rate environment currently and the growth side of the market is contracting. The questions are, is this correction premature? Do interest rates have staying power at the current level and can they go higher? We're not sure, but we can offer you this; there's approximately $5 trillion dollars in cash sitting on the sidelines globally, $4 trillion in the US, earning virtually zero. Almost every country globally is in some form of quantitative easing. These are all metrics that suggest quantitative tightening is still off in the future. So, short rates will probably stay low while the fear of inflation will create volatility and push the direction of longer rates. Stay tuned in and we'll keep you updated on this relationship.

Economic News

- Monday:
    - Markit Manufacturing PMI (final) for Feb., 58.6 vs. 58.5 expected and 58.7 previously…above 50 is expansionary.
    - ISM Manufacturing Index for Feb., 60.8% vs. 58.9% expected and 58.7% previously…same, expansionary.
    - Construction Spending for Jan., 1.7% vs. 0.8% expected and 1.1% previously…excellent.
- Tuesday:
    - Motor Vehicle Sales (SAAR) for Feb., 16.0 million vs. 16.6 million previously…improving.
- Wednesday:
    - ADP Employment Report for Feb., 117,000 vs. 225,000 expected and 195,000 previously…still slowing.
    - Markit Service PMI (final) for Feb., 59.8 vs. 58.9 expected and 58.9 previously…excellent.
    - ISM services Index for Feb., 55.3% vs. 58.7% expected and 58.7% previously…excellent.
- Thursday:
    - Initial Jobless Claims (state, SA) for Feb. 27th, 745,000 vs. 750,000 expected and 730,000 previously…holding.
    - Continuing Jobless Claims (state) for Feb. 20th, 4.30 million vs. 4.42 million previously…holding.
    - Productivity revisions for Q4, -4.2% vs. -4.7% expected and -4.8% previously…better.
    - Unit Labor Costs revision for Q4, 6.0% vs. 6.6% expected and 6.8% previously…still advancing.
    - Factory Orders for Jan., 2.6% vs. 2.3% expected and 1.1% previously…accelerating.
- Friday:
    - Nonfarm Payroll for Feb., 379,000 vs. 210,000 expected and 49,000 previously…very good, especially for the leisure and entertainment industries.
    - Unemployment rate for Feb., 6.2% vs. 6.3% expected and 6.3% previously…flat.
    - Average Hourly Rate for Feb., 0.2% vs. 0.2% expected and 0.2% previously…flat.
    - Trade Deficit for Feb., -$68.2 billion vs. -$67.6 billion expected and -$66.6 billion previously…importing inflation/deflation.

While we had a light week for earnings of companies in our portfolio, earnings were good almost across the board, especially in retail. The consumer seems to be spending and the economy's improving. The vaccine seems to be rolling out better with approximately 50 million Americans now receiving at least one shot and 21 million having both. President Biden projected that there would be enough vaccine to vaccinate all Americans by the end of May. Let's hope this is true, we need herd immunity to get back to some sense of normal.

Stay safe!

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