FINANCIAL LEVERAGE AND INTEREST RATE TRENDS

NCMC Investment Club

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Reaching financial success is a marathon, not a sprint.

Slow and steady wins the race.

BEST POLITICAL QUOTE FOR ANY ERA

"The Budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed, lest Rome becomes bankrupt. People must again learn to work instead of living on public assistance." -- Cicero, 55 BC.

So, evidently, we've learned absolutely nothing over the past 2073 years!!

Impact of Federal Debt on LT Rates

The long-term interest rate will be driven higher by:

- rising short-term rates as the Fed normalizes monetary policy
- higher inflation in response to tighter labor and product markets + tariffs
- the explosion of the federal debt that needs to be absorbed by investors.

The federal government is scheduled to borrow more than $1 trillion in 2019 and subsequent years (that's about 5% of GDP).

The Congressional Budget Office projects that the federal debt held by the public will grow from 78% of GDP now to nearly 100% over the next decade.

Although foreigners now own about 50% of publicly held U.S. government debt, recent reports indicate that foreign buyers are remaining on the sidelines and domestic investors are currently buying all of the new government debt. As the total amount of debt increases, investors will demand higher long-term interest rates to purchase it.

The rise in long-term rates will reduce the present value of future corporate profits and provide investors with an alternative to equities. The result will be a headwind for share prices.

U.S. Budget Deficit rose 17%

- The U.S. Federal Deficit rose to $779 billion in the fiscal year ending September 30, an increase of $113 billion, as spending climbed 3.2% while revenue remained nearly flat at +0.4%.
- Compared to GDP, the deficit rose to 3.9%, up by 0.4 percentage points.
- President Donald Trump asked his Cabinet to propose major belt-tightening. "We're going to be asking for a 5 percent cut from every secretary,”
- A reduction in federal spending of that magnitude hasn't happened since the Eisenhower administration.

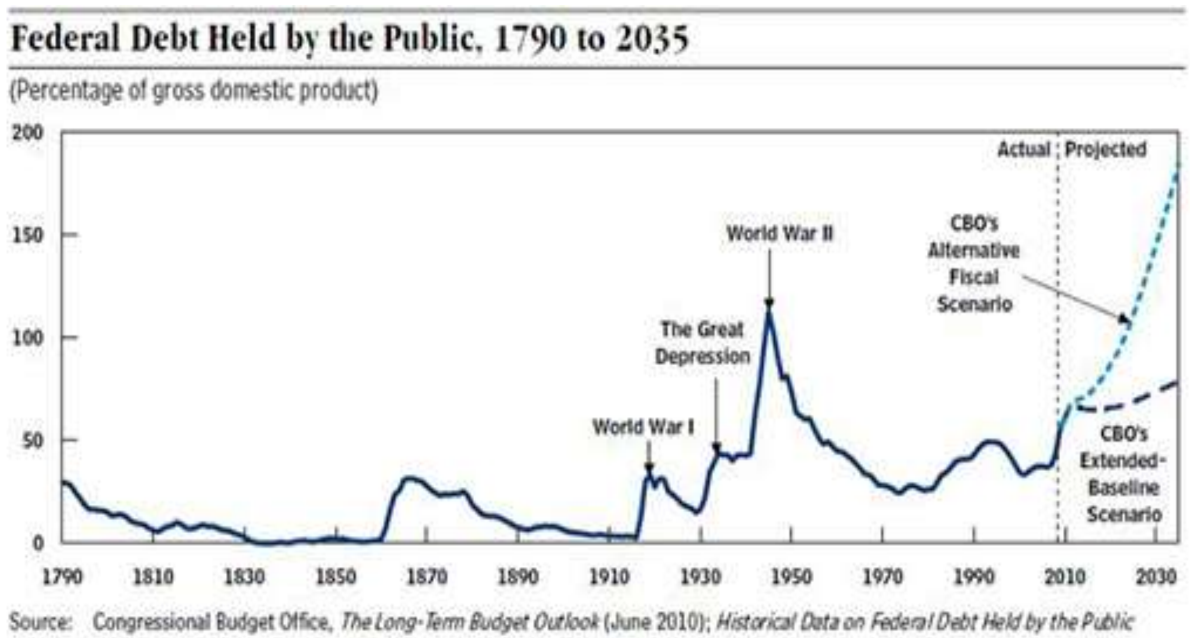
Corporate Taxes

- Prior to tax reform, the U.S. had a corporate tax rate that was just under 39%. That consisted of a 35% federal tax rate on corporate income, with the remainder coming from state taxes. That put the U.S. in the top three countries in the world in terms of corporate tax.
- Now, federal rates on corporate income have fallen from 35% to 21%. That puts the total federal and state burden at around 24%, just above the worldwide average of roughly 23%.
- Proponents of tax reform argue that lower corporate tax rates will boost business profits, leading to greater levels of economic activity that should result in higher wages over time. Opponents argue that lower business tax rates will only concentrate more wealth in the hands of high-income taxpayers.

Repatriated Cash

- American companies have returned some of their profits held overseas after President Trump cut corporate taxes for the first time in 31 years, but most of their $3 trillion money pot remains parked offshore.
- The government said U.S.-based companies returned $465 billion in cash in the first half of this year, $295 billion in Q1 and $170 billion in Q2.
- Now $465 billion in repatriated cash is not exactly chump change. Yet it’s only about one-sixth of an estimated $3 trillion or more in profits that U.S. companies have parked overseas.

Federal Debt to GDP ratio



ADD Fed QE redemptions

- The budget deficit will come in at just over $1 trillion next year. That’s about 5% of GDP, a record excluding wars and recessions. But then add Fed QE redemptions of about $200 billion, and that brings Treasury financings up to 6% of GDP.
- End of Quantitative Easing and begin of Quantitative Tightening - the unwinding of the massive $4.3 trillion balance sheet of the Fed is a headwind, as it raises borrowing costs (interest rates)

Unsustainable Path

- US Federal Deficit to GDP ratio: 1980: -1.2%: 1990: -3%; 2000: +1.3%; 2010: -9.7%; now: -4%.
- The accumulated federal deficit over the next decade will be $1.6 trillion larger than it would have been without the recent tax cuts and spending increases, according to the CBO.
- White House budget chief Mick Mulvaney says a growing economy is “an important step to long-term fiscal sustainability.”
- Both Jerome Powell and Janet Yellen said that the national debt is on an unsustainable path.
- Mitch McConnell called the rising budget deficit “very disturbing.”
- Trump wants a major tax cuts for middle class: tax plan 2.0.
- It looks like the nation’s need for increased infrastructure investment, estimated at $1.4 billion, goes unmet.

Suicide Mission

- It looks like there is little interest in containing deficits during good times, the result could be a costly backlash during the next bust.
- Keynesian economics call for deficit spending and lower taxes during economic slumps to stimulate demand, with the money recouped through surpluses during good years. That last part isn't happening.
- Also, Social Security's fiscal condition is deterioration and Medicare's challenges will keep growing.

Global debt – 3x global GDP

- Another crisis is inevitable, because booms and busts are rooted in the primal human emotions of fear and greed. Economist Hyman Minsky observed that as past crises fade from people's memories, financial markets become prone to new bursts of binge borrowing and speculative excess.
- Many see debt as the likely culprit of the next crisis, the way subprime mortgages were in the last one.
- Around the globe, countries have taken to the idea of running constant deficits as the normal course of business, and too much accumulation of debt is not healthy for countries or the global economy as a whole.
- The world's total household, corporate, and government debt hit $247 trillion in the first quarter, 318% of global GDP, according to the Institute of International Finance. That's nearly 40% higher than the $178 trillion in the pre-crisis first quarter of 2008.
- The sheer size of that debt means governments will be hard pressed to put out the next wildfire.

Corporate Debt

- Corporations have built leverage back to pre-recession highs in order to return cash to shareholders via stock repurchases and dividends.
- Despite historically low interest rates, corporate interest expense has soared to a record. Given that debt burden, companies started curtailing their borrowing this year.
- United Technologies, for instance, said it will be focusing on deleveraging for the next few years, and does not expect any significant share buyback in 2019.
- With the economy firing on all cylinders, demand for credit would normally be surging. The new reluctance to go deeper into debt is proof of just how low the threshold of interest rate pain has become, thanks to massive post-crisis leveraging,
- At the very least we should tactically avoid highly leveraged companies.
- Companies that have no debt can't go bankrupt.
- A normal corporate balance sheet has 75% equity and 25% debt; debt /equity ratio of 33%.

Credit Card Debt

- The average U.S. household owes $16,061 in credit card debt, up 10% from $14,546 from 2006.
- That figure is still down from the recent high of $16,912 at the height of the recession in 2008.
- Credit card debt levels aren't expected to hit pre-recession levels until the end of 2019.
- Interest rates play a large role in the debt. The higher the rates, the higher the debt.

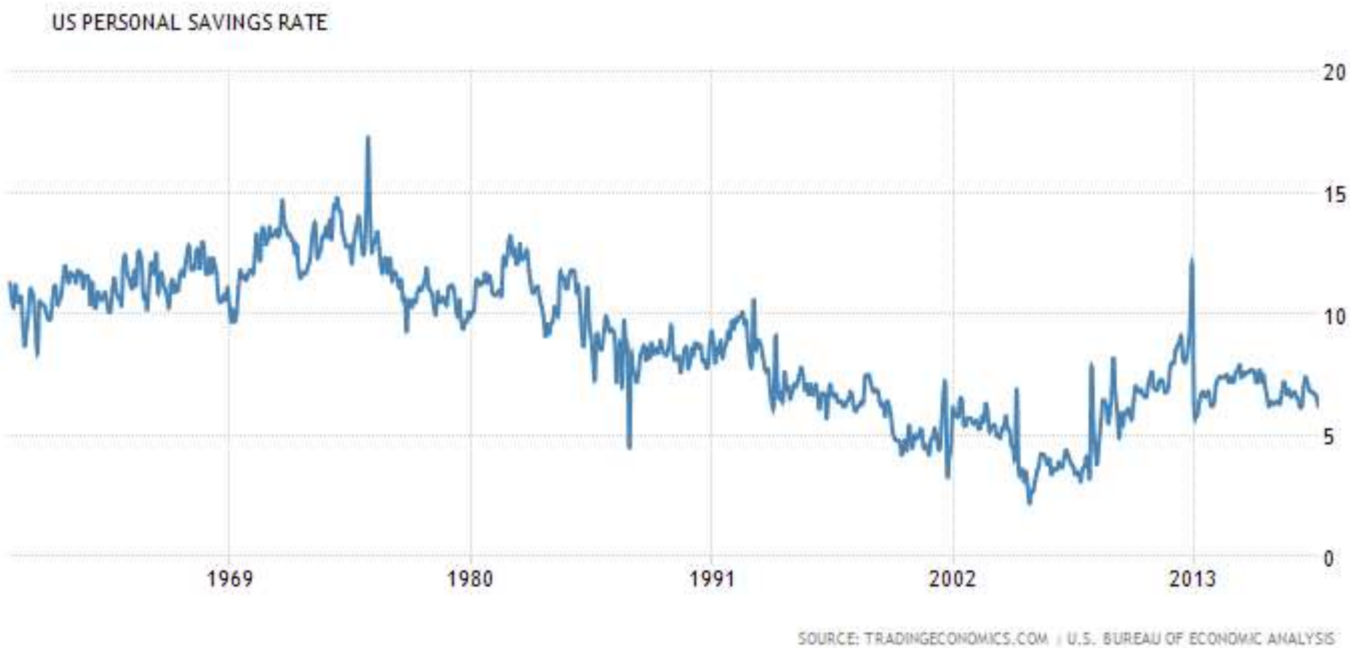
Other Personal Debt

- Consumer debt at $4 trillion is at an all-time high.
- Americans are more burdened by student loan debt than ever. They owe over $1.48 trillion in student loan debt, spread out among 44.2 million borrowers ($33,500 on average). That's about $620 billion more than the total US credit card debt.
- Student loan delinquency rate of 11.2% (90+ days delinquent or in default).
- One measure of leverage in the stock market is margin debt. Margin debt has soared for nine years in a row and at $650 billion exceeds the prior peak of July 2007 ($416 billion) by 56%.

Low Savings Rate

- Sadly, America has one of the lowest savings rates in the developed world.
- Part of the blame goes to the government, which continues to punish savings by taxing capital gains and dividends, while rewarding debt with tax deductions on interest payments.
- Household Saving Rate in the United States decreased to 6.20 percent in September from 6.60 percent in August of 2018.
- Personal Savings in the United States averaged 8.82 percent from 1959 until 2018, reaching an all time high of 17.30 percent in May of 1975 and a record low of 2.20 percent in July of 2005.

US Personal Savings Rate



Emerging Markets

- Emerging markets are going through a slow-motion crisis, fueled by falling commodity prices, weakening currencies, and a drawn-out slowdown in China.
- A buildup of dollar-based debt in the government and private sectors is getting harder to repay as trade conditions deteriorate and local currencies lose value versus the U.S. dollar.

Connecticut

- By many measures, Connecticut's debt levels are the worst of the 50 U.S. states.
- The ballooning payments for public employees’ guaranteed pension and health benefits for public employees and teachers are the main cause of Connecticut’s fiscal misery.
- $50 billion of unfunded pension liabilities, only 30-35% of liabilities are funded.
- Today, Connecticut is 46th in economic growth, 46th in road quality, 47th in state-pension funding, 47th in population growth, 50th in personal income growth since 2007, and since 1992 50th in employment growth.
- Many citizens are leaving the state and corporations like GE, UBS, Alexion Pharmaceuticals and Aetna left as well.

Underfunded Public Pension Plans

- The fiscal monitor database shows that U.S. state and local government employee pension plans are a little more than 70% funded. The actual funding rate is less than 50%.
- The typical U.S. public pension plan estimates its liabilities using a discount rate of 7.4%, compared with a 30-year Treasury yield that has spent most of the past decade at 3% to 4%. Using the correct discount rate raises the U.S. public employee pension obligations by about 50%.

Inflation

- Interest rates are still low and inflation is benign
- Higher inflation means higher interest rates and higher costs to service debt
- Unemployment rate at 3.7% - lowest since 1969; wages are rising
- CEOs warn of inflation heading into 2019 due to rising production and materials costs and new tariffs
- Tariffs will either get passed on to the consumer (inflationary), reducing their ability to spend, or they will hit the producers, which will drive down earnings and squeeze profit margins
- A 2% annual inflation rate destroys almost 50% in real purchasing power after 30 years. A $50,000 investment in a conservative stock/bond mixture will almost triple with a 3% real return over the same period – Rithold Wealth

Conclusions

- Overall Debt levels are too high for this time in the economic cycle. This will hurt us in the next recession.
- We are probably not growing our way out of it.
- Interest rates are on an uptrend, which will make servicing large debt loads more expensive.
- Nobody seems to care, neither Republicans nor Democrats. Voters don’t take it seriously until markets react.
- It is probably too early to worry about a potential U.S. sovereign debt crisis, but we should not ignore lessons from history on the fragility created by debt.
- When federal debt hits 100% of GDP, it could shake people up, but it is already above that level if you include unfunded pension liabilities.
- My view: It is much better to fix your roof when the sun is shining than when rain is coming through your light fixtures.