The Wrap Up

And on Tuesday, I'm Gonna ~~Hug~~ Downgrade ya Debt

Fitch, a credit rating agency, downgraded US debt from the top rating of AAA to AA+ due to "steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters". Let's look into how we got here and what it means for investors moving forward.

The United States is the most important nation in the modern economy; its largest export, the US dollar, makes up 60% of total reserves and is the reserve currency of choice for the majority of the global economy. Global trade often takes place in USD, with almost all commodities trading and settling in dollars as well. The country is also a large exporter of software, microprocessors, medical equipment, medicine, military equipment, automobiles and media. It plays an important role in geopolitics and culture, with English (its common language) the most spoken language in the world (Britain being the superpower pre-World War II also helped make this possible, that historical fact is not lost on me). Unfortunately, the country has been dealing with many political issues that have manifested into social and economics ones, with all these issues coalescing into the situation we see in the US today.

Prior to me starting my career in finance, the United States never had its debt downgraded; since then it has happened twice (in 2011 when debt ceiling drama promoted the first downgrade from Moody's and now, with this week's downgrade). Either I am a bad omen for the US's credit rating or this just the beginning of a new normal. For what it's worth, the credit rating may have changed, but the standing of the US dollar has not; all the noise around the de-dollarization of the global economy comes from countries or individuals on the losing end of economic sanctions. Over the last 15 years, the US realized that waging war was expensive and that economic sanctions were a less expensive way of causing damage to its opponents.

As mentioned earlier, the world runs on US dollars, so when an individual or a company is sanctioned, it becomes difficult operating normally; raising debt

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becomes impossible, trading with other firms can't occur and access to clearing networks (CHIPS) and cross-border messaging systems (SWIFT) is removed. Over time, the increased weaponization of the US dollar has left behind a large list of countries and dictators pushing for alternatives. The Economist had an article in January 2020 titled "America's aggressive use of sanctions endangers the dollar's reign" foreshadowing this risk. Three years later and China and Saudi Arabia are trading oil for Yuan.

Let's not get ahead ourselves, however, as the odds of a de-dollarized economy are still quite low and we are likely 30+ years out for that potential outcome altogether. This week's credit downgrade is merely a reminder that America can no longer take its position of power for granted. The other side to this story is political; something few people in this industry are comfortable discussing. The truth of matter is that political opinions are now rooted in peoples' emotions and their identities; legislation takes a back seat to this and rational political conversation is almost non-existent. While we turn a blind eye to this unfortunate reality, we are not insulated from the consequences of poor governance and this is why America has been dealt a downgrade on its debt rating.

The country's political system has become extremely polarized; a great deal of the conversation is cynical in nature and light on solutions. It was not too long ago that President Bill Clinton left office with a small budgetary surplus, while his successor, President George W. Bush, celebrated with tax cuts and two expensive wars. The onset of the financial crisis of 2008 further impacted the debt level with massive amounts of spending needed to avoid a disaster. The TARP program and Recovery Act, passed by Presidents Bush and Obama are the reasons why we did not have a 1930's style depression; the economy recovered and experienced an 11 year run without a recession. This came at a tremendous cost, however, as debt levels ballooned from $8.5 trillion in 2006, to $13.5 trillion by 2010.

Some of the spending post financial crisis was justified as confidence in the economic recovery was still low at the start of decade. This is where the first debt downgrade evolved from, a government shutdown over a debt ceiling debate. While a crisis was averted, a divided government limited President Obama from making any major changes for the remainder of his Presidency. President Trump was gifted both chambers of Congress and was able to pass another tax cut which increased the debt by $3 trillion by the end of 2019. Covid brought on a new wave of spending with the debt exploding to $30 trillion by the end of 2022. Again, while some of the spending was entirely justifiable (especially at the onset of the pandemic), fiscal discipline seems to be an afterthought at the moment. Different from what we experienced during 2008 and early 2020, when the support was very much needed, the ongoing stimulus that replaced incomes which were not lost, likely contributed to the increase in inflation we are currently dealing with.

Today, the country is still coming to grips with large budget deficits and while we are fans of three big spending bills (the Infrastructure Act, the CHIPS Act and the Inflation Reduction Act), there needs to be some form of restraint on spending moving forward. The large deficits are unsustainable, especially in a higher interest rate world. Annual debt servicing jumped 25% in the first nine months of the fiscal year, reaching $652 billion. As that figure continues to rise there will be fewer dollars available for program spending and should there be another economic downturn, the government risks not having the capacity to support people as it would like to.

Government spending will likely have to come down, which will have a negative impact on economic activity for some time. It is for this reason that we expect more modest returns for equity markets than what we experienced in the previous decade. This does not mean that markets will be bad, nor does it suggest that we will not have sequences of strong returns (as an example, the first half of the year was amongst the best in history for the NASDAQ). However, when you average it out, the market may only see a high single digit return average for the years ahead. For this reason, we have prioritized efficient returns; covered call mandates and income notes that can already achieve returns above 8% are very appealing in this world. For our clients, expect a balanced approach between companies that we believe are likely to remain important in the modern economy with ideas that combine high yield with lower risk taking.

Healthy Distraction

Rapper Post Malone paid $2.2 million for the extremely rare 'One Ring' card, released by Hasbro for Magic: The Gathering. According to Forbes, the odds of finding the card (a one of a kind) was 0.00003%. A lucky Toronto man by the name of Brook Trafton will be celebrating a healthier bank account this week. In the last couple of years, collectible trading cards have exploded due to a perfect storm of nostalgia and pandemic stimulus. Pokémon cards have sold for $5 million with some rare sports cards easily eclipsing $1 million. Parents, if you have boxes of collectible cards that your children left behind, do some research on the internet before you throw them out or you may be throwing out your golden ticket! And to all the millennials reading this, your Pokémon or basketball rookie cards from the 1990s could be worth hundreds of thousands of dollars; do not trade them on Kijiji for $300, unless you've already cross referenced them with an online database and know their value!

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