The Wrap Up

Mother Should I Trust the Government?

Outside of a few notable quarterly results and an in-line inflation reading, the dominant headline this week was the potential of a US default. The consequences of the world's largest economy not meeting its obligations would be disastrous, with unquantifiable impacts on the world economic order as well as for investors. As we covered the topic a couple of weeks ago, we will touch briefly on the topic this week and we'll recap some of our observations within the market.

The US no doubt has a spending problem but it has a bigger problem with its increasingly polarized society, where parties go out of their way to 'own' the other side, often at the detriment of the majority of Americans. The United States debt stands at $31.7 trillion or 120% of GDP as of Q4 2022. Spending is necessary but it can no longer be wasteful; everything should be on the table from social benefits that discourage people from participating in the work force to corporate subsidies that are propping up failing industries. It would also help for the country to have a serious talk about taxes and by serious, they must stop giving the spotlight to the most extreme positions. It does not matter that leftists have good intentions, America is economically and culturally nothing like Scandinavia; to keep promoting that vision is as divisive as it is unrealistic. On the flip side, right wingers must also accept a sensible tax policy and need to stop offering tax cuts to those who do not need them. It is worth noting that the last time American debt-to-GDP was at these level was after World War II (followed by a four decade period of large declines) where tax rates were much higher and social spending was on the rise. There are other factors unique to the time which may not apply today, however, it is also worth highlighting that debt-to-GDP only started increasing in the 1980s after the famous Regan tax cuts.

The US debt situation, like most obstacles in life, requires a balanced view point. What makes the American economy and culture what it is that it fosters a tremendous amount of innovation. Innovation leads to productivity gains, which leads to real economic growth which leads to an overall improvement in quality of life. It achieves this because it has a smaller social safety net than its European counterparts, creating a sink or swim mentality that has brought them to the point they are at

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today. What characterized America's economic ascent was an increasing quality of life for a greater number of people; something that has stagnated for several decades. This is where spending and regulation is needed to restore balance: America must invest in its people so that they can meet their needs but it cannot aim to subsidize the wants of everyone. There are minds within both parties that understand this and are looking to compromise for the greater good of the nation, however, divisive politics where peoples' identities are far too intertwined with the party they support (or against the party they oppose) gives greater power to those who sit on the extremes. Somewhere along the line, Americans forgot that the people in the other party are still Americans and while I do not believe polarized politics will end any time soon, a compromise on the debt ceiling is still possible.

Spending, or overspending, has contributed to the current economic situation where we've had to raise interest rates at a rapid pace in order to slow down inflation. The consequences we face today serve as a reminder that government spending must continue to be properly thought out or we, the people, will continue to suffer real consequences. The increase in interest rates has already impacted people and businesses with a higher debt burden and, as our base case suggests, it will have a greater impact as job losses increase and corporate profits lag. For the moment, investors have been insulated from the worst of these consequences; the market is positive overall, with the S&P 500 up 7.5%. It would be a mistake, however, to confuse strong index returns as a sign of strength within the markets. Consider the breadth of the S&P 500; the weighted return of the four largest components of the index (Apple, Microsoft, Amazon and Nvidia) is 7%. What that means is the other 496 companies represent 0.5% of the index's year to date return. Like index returns, macro economic figures can often be misinterpreted in a similar manner; a strong top line figure can mask internal weakness. It is for this reason, that we have maintained our conservative bias throughout the year.

There are three possible paths towards stable prices and more stable economics: either a severe recession, a long period of stagflation or a bit of both. The demand for workers, for goods and services still exceeds what we can produce (both in the US and Canada) which is why central banks have raised interest rates with the goal of slowing down aggregate demand. A year into the rate hiking cycle has somewhat slowed demand while the labour market hasn't really improved. A steep recession would fix that but it would also come with undesired consequences, complicated by the high debt levels of government and individuals. We can also live through a decade where inflation stays above target, the path for interest rates remains limited and growth stays below trend. In this scenario, enough time elapses for things to improve organically; a new generation of immigrants are now part of the labour force, debt-to-nominal GDP improves because of the higher inflation and weak returns force more efficient capital allocation. There are risks that come with this possibility: risk taking will be limited which will have a direct impact on innovation and productivity and asset returns will be weak and have an impact on those who rely on their savings to live. The mild recession coupled with 12-24 months of slightly higher than desired inflation with slightly lower than expected economic growth sets us back to normal with the least amount of economic pain.

For our clients, this is why we are prioritizing best-in-class ideas and efficient yield. The return to normal has a small chance of being achieved without a tradeoff, therefore, asset returns will likely be more muted than what we were accustomed to in the previous decade. Rest assured, if we are wrong, we have plenty of exposure to emerging ideas like AI and solar energy, and, we can quickly pivot towards more of these ideas.

Healthy Distraction

This weekend is Mother’s Day and we’d be remiss not to highlight the integral role that mothers play in our lives. Every person alive on Earth today is here due to their mother’s willingness to sacrifice and carry them for nine months, so we all have that in common. Even after we’re born, the effort that goes into raising a child is greater and, although fathers share responsibility in this department as well, mothers have often, historically and culturally, been tasked with a greater number of responsibilities in the earlier years of a child’s life.

Mothers aren’t always biological, however, as remarried couples can sometimes have children from previous marriages or through adoption. Yet, regardless of how they came to be a mother, a Mother will always be a Mother to their child. We are lucky to have a role in our society, in our households, as selfless as a Mother; it has been argued that many human traits such as compassion and empathy evolved from motherhood. Without those traits, society and humanity would be very different from what we see today. In the animal kingdom, few species have a maturing period as long as humans; some animals are independent immediately at birth while more and more people are living at home past the age of 30.

The role of a Mother never stops, even after we leave home and, while we’ve created a day to recognize the importance of that role, we should value and honour our Mothers every single day.

To my Mother, my Step Mother, my Mother-in-law and all the Mothers out there; Happy Mother’s Day!