

The Wrap Up



Train Kept a Rollin'

This week was noteworthy as both the House and the Senate voted for, and passed a deal that will involve raising the debt ceiling. It's an important move that avoided what would have been an economic catastrophe, however, it does not sufficiently address long term risks around America's long term spending. Let's recap the deal and address the economy's continued strength.

The debt ceiling drama, which captured the attention of market participants for the last couple of weeks came to an end this week, however, the concessions agreed upon make it feel like the drama build up was for nothing. Maybe our judgment is a bit harsh, after all it is estimated that this deal will reduce spending by \$1.3 trillion over the next decade, as per the Congressional Budget Office. However big the spending cuts are estimated to be, they pale in comparison to America's estimated spending in that same time period: \$80 trillion.

America's two budgetary issues are linked to expenditures and revenues. Pensions and medical insurance make up almost two-thirds of federal spending (both of which are expected to rise as the population ages). While tax revenues as a percentage of GDP are, by a sizable margin, the lowest amongst G7 nations and below the OECD average (26.6% in 2021 versus 34.1% average). Unfortunately, entitlement spending and taxation were both off the table during this negotiation. If you're serious about addressing a problem, you'll attempt to address the most glaring issues; as such, by the end of this decade, it is estimated that America will spend more on interest payments than on defence.

The overspending and under taxing may explain why America's economy continues to defy the odds this year, growing when a recession was predicted and adding jobs every month that exceeded forecasts. Just this morning, US payrolls came in at 339k, almost doubling the expected 186k. While the headline figure does not explain the entire story (unemployment actually moved up 3.7%), this year's economic strength has humbled many forecasters. As BMO's chief

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economist, Doug Porter stated recently: “one could make the argument that if the big forecasting mistake almost everyone made in 2022 was to underestimate inflation... the big mistake, 40% of the way into this year, appears to be that almost everyone has underestimated the resiliency of the economy”.

We have maintained our cautious approach to investing throughout 2023 and we are comfortable to maintain it. Our exposure to technology (especially centered around chips and AI) have allowed our equity performance to keep in line with the S&P 500 even though we have a 25-30% exposure to Canada (which, at 1.15% YTD, is almost 8% lower than the S&P 500's 9.9%). This outperformance on our end has come at a time where we shifted towards income notes (that offer high fixed returns but do not participate in market upside) and regularly trimmed our individual outperformers. There is a lot to be proud of this year, considering the challenges we faced because of our growth tilt in 2021. By remaining attentive to risk in the short term but not ignoring the medium and long term trajectory of the economy, the portfolio and our clients are having a strong year so far.

On the subject of medium and long term trajectories, we pivot back to the spending debate in the United States and elsewhere in the world. The OECD average of general government debt to GDP sits at 90% in 2022. The United States, along with Canada, Italy, France, Japan and the United Kingdom all have debt that exceed 100% of GDP with the trend levels even more alarming. All these countries, and many others, are still projected to run deficits which will add to their debt levels, at a time where economic growth is positive and while interest rates are the highest in almost 20 years. Of note, the last time interest rates were at this level, the OECD average debt to GDP sat at 52% and only Italy and Japan had exceeded 100% within the G7 economies. While governments today are tempted to score victories for their voter bases, many of these wins are short term in nature and risk causing everyone long term headaches.

Unfortunately, we have real world examples of what happens when spending gets out of control: welcome Greece to the conversation. The combination of weak state finances, coupled with the financial crisis of 2008 and the subsequent Euro crisis of 2011 pushed the country to the brink of default. Multiple bailouts, along with unpopular austerity measures were needed to stabilize the situation, followed by several years of high unemployment and economic stagnation. Today, the Greek economy looks healthier (growing at almost twice the pace of the euro zone), however the Greek people will not forget the suffering and regression to their living standards that they had to endure. We were quite lucky that Greece was small enough to bailout, what would have happened if it was Italy and its \$2 trillion of debt? What would happen if it's America that needs a bailout?

With the raising of the debt ceiling, we live to fight another day but we should take advantage of the time we bought to seriously contemplate our trajectory. House Speaker Kevin McCarthy proposed a bipartisan commission to address the finances of the country. This commission will accomplish little if it chooses to bury its head in the sand around entitlement spending and taxation; we remain hopeful that, when the time comes, the difficult decisions are made of our own accord as opposed to having no other choice.

Healthy Distraction

Summer may not be here yet but this week was our first heat wave of the year. What made this week a little more tolerable was the lack of humidity; it was kind of refreshing to have some dry heat in Montreal for a change. To the chagrin of many (I'm assuming) this week's Healthy Distraction is not a weather report, however. Keeping with the theme of summer, I thought to share a summer playlist to enjoy:

Higher Ground – Stevie Wonder

Twistin' the Night Away - Sam Cooke

Cose Della Vita – Eros Ramazzotti with Tina Turner (RIP)

Le temps de l'amour - Francoise Hardy

Soul Sister, Brown Sugar - Sam & Dave

What Makes a Good Man? – The Heavy

Uncle Remus – Frank Zappa

School's Out – Alice Cooper (on a side note I was so disappointed to learn that my niece had no idea about this song. Parents, please introduce your children to the seasonally appropriate music of the past!)



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