HFG WEALTH MANAGEMENT

INSIGHT

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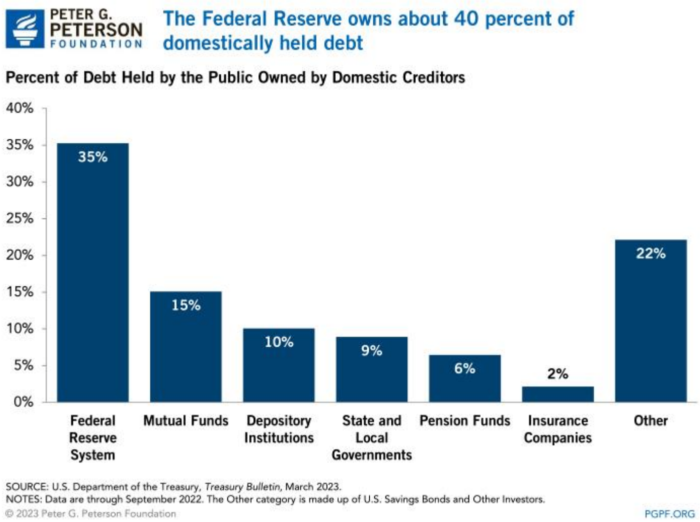
PERSPECTIVES FOR THE GOAL-BASED INVESTOR

Henry Pizzutello - Chief Investment Officer

The Ticking Debt Bomb

One of the primary concerns for investors has been the tremendous increase in the U.S. debt levels. We are currently at approximately $33.4 trillion, having eclipsed the previous debt ceiling earlier this year. While we have just been given a reprieve by Congress, the problem remains to be dealt with on a permanent basis. Since 1960, that limit has been upped or extended about 80 times, so it seems that fiscal responsibility is a moving target when left to politicians. The amount of federal debt issued to the public can affect the country's fiscal and economic health in a number of ways. The nation's high and rising levels of such debt can affect economic growth and poses a number of risks.



- Reduce private investment and slow the growth of the economy
- Increase interest payments to foreign holders, thereby potentially reducing national income
- Elevate the risk of a fiscal crisis

However, is the debt issue really that much of an issue? There have been many arguments that the overall debt does not really matter "since we owe it to ourselves" and as long as we make the interest payments there is really no long-term effect. To answer this question, we need to understand who owns all of the U.S. debt.

First off, while the overall debt is $33 trillion, about $7 trillion can be classified as intragovernmental holdings. This is basically debt the government owes itself. The Social Security Administration, the Department of Defense and the United States Postal Service all have investment holdings in federal debt. While this is a significant dollar amount, it is less important to the entire debt picture because it is a net zero on the overall balance sheet,

The remaining amount is debt held by the public at more than $26 trillion. This represents securities like Treasury bonds and notes, bought by banks, insurance companies, state and local governments, foreign governments and private investors. This is the most meaningful measure of debt, because it reflects the amount that the Treasury has borrowed from outside lenders. Of this $26 trillion, the

Federal Reserve is the largest holder. The Fed has doubled its borrowings to $9 trillion over the past few years, as a result of the stimulus programs relating to COVID. Of such debt – however, the Fed has generally been reducing the size of its balance sheet to combat high inflation.

Foreign Holders of Federal Debt

Foreign ownership of U.S. debt, which includes both governments and private investors, stands at about $9 trillion, which is a much larger percentage than it was about 50 years ago. In 1970, total foreign holdings accounted for 5% of public debt – today that figure is close to 30%. However, foreign holdings have decreased in recent years, after peaking at 49% in 2011.

Foreign ownership of U.S. debt can have implications for the nation's economy and financial markets. When foreign investors purchase Treasury securities, the federal government must send income abroad in the form of interest payments. If foreign investment is used for productive purposes, such as stimulating recovery from a recession or funding investments in the nation's economy, that is a beneficial use of debt. However, we have seen recently that much of the debt increase has not been tied to productivity.

The Effect of Interest

The biggest issue facing the U.S. in the upcoming years will be the cost of servicing the debt. This had not been a problem when we were in ZIRP mode (Zero Interest Rate Policy) post Financial Crisis, as the cost to service the debt were manageable – even as the overall amount of debt increased. However, over the past two years that service cost has increased significantly, and debt service will become an increasing problem going forward.

According to the Congressional Budget Office. he government already spends more on interest than on budget areas such as veterans' benefits, transportation, and education. In 2024, we will spend more on interest payments than the total portion of the federal budget allocated to children. The current CMB projections get worse:

- In fiscal year 2028, the federal government will spend more on interest than on defense.
- In fiscal year 2031, the federal government will spend more on interest than on non-defense discretionary, which includes funding for transportation, veterans, education, health, international affairs, natural resources and environment.

To visualize how large interest costs would be at the end of the current projection period, consider that such costs would represent 13 percent of all spending in the budget in 2032, which is almost double what we are currently facing today.

Increasing debt is not always a negative circumstance. Borrowing used to make capital improvements or investments in infrastructure that lead to economic growth is considered to be positive. However, very little of the federal budget is allocated to investments such as spending on education, infrastructure, and research and development. In fact, if current policies stay in place, interest costs would exceed what the federal government has historically spent on key investments within the next decade. Without a significant change in the way government uses its balance sheet, the CBO projects that interest will exceed the amount spent on Medicare in 2044 and Social Security in 2050, at which point it will be the largest expense in the federal budget.

Investing in an elevated Interest Rate and Inflation Environment

Both high interest rates and high inflation are significant factors that can impact investors, and their relative importance depends on one's specific financial goals, risk tolerance, and investment strategy. Interest rates and inflation tend to be correlated and when interest rates rise, as they periodically do to combat inflation in economic cycles, various asset classes respond differently. Investors must adapt their portfolios accordingly to maximize returns and manage risks.

Bonds

Traditionally, bonds are negatively correlated with interest rates. As rates climb, the prices of existing bonds fall, leading to capital losses for bondholders. However, these losses can be mitigated by holding shorter-term bonds, which are less sensitive to rate fluctuations, or alternatives to fixed income, that are less correlated to interest rates. In "normal" market environments, bonds have traditionally acted as a hedge against equity declines – they tend to go up when equities go down. However, this negative correlation has been turned upside down over the past three years. During this period, when equities have had a negative month, bonds have followed, negating the defensive effects in portfolios. This change in correlation is something that needs to be carefully monitored in the future for successful portfolio performance.

Equities

Historically, stocks have shown mixed performance during periods of rising interest rates. While higher rates can increase borrowing costs for corporations and reduce their profitability, the impact is not uniform across all sectors. Value-oriented sectors, such as financials and industrials, tend to benefit from rising rates as they typically have strong cash flows that tend to mitigate the higher interest rates. Banks and financial institutions typically see their profitability increase as the spread between short-term and long-term interest rates widens. When rates rise, banks can charge more for loans while their own borrowing costs remain relatively stable. Consequently, financial stocks tend to outperform in a rising rate environment. This sector includes banks, insurance companies, and investment firms. However, this year is the **first time in 100 years that banks have underperformed the S&P in the year following a bear market**.

Growth sectors like technology and consumer discretionary may experience headwinds due to higher discount rates. The technology sector especially, can be more sensitive to rising interest rates. Higher rates increase the discount rate applied to future cash flows, potentially reducing the present value of tech companies' future earnings. As a result, technology stocks may underperform during periods of rising rates. However, not all tech companies are equally affected, and those with strong fundamentals and cash flows may continue to thrive.

Commodities

Commodities are often viewed as an inflation hedge, and they can perform well in higher interest rate environments, especially if rising rates are driven by inflationary pressures. Assets like gold, silver, and oil tend to appreciate during periods of economic uncertainty and rising prices. Investors can use commodities to diversify their portfolios and protect their purchasing power in a rising rate environment.

The energy sector benefits from rising interest rates. Oil prices are often positively correlated with economic growth, and a robust economy can drive up energy demand and prices. Furthermore, many energy companies have reduced previously high levels of debt, and rising rates can lead to increased revenues from their energy production, improving their ability to increase cash flow.

The Relative Importance:

Importance of Real Returns: Inflation highlights the importance of achieving real returns, i.e., returns that outpace the rate of inflation. Investors must consider investments that not only provide nominal returns but also protect against the eroding effects of inflation. While there is no clear-cut choice as to the best investment for either scenario, an investor must consider their specific financial goals and circumstances:

Income-Oriented Investors: Those who rely on investment income, such as retirees, may prioritize high interest rates as they seek stable cash flows from fixed-income investments.

Long-Term Growth Investors: Investors with long investment horizons and a focus on building wealth over time may be more concerned about high inflation eroding the real value of their investments. They may prioritize assets that historically have provided real returns even in inflationary periods. Growth equities, even though they may have large price volatility, tend to be the most suitable investment over the longer term, if there are no significant needs for capital in the interim.

Economic Environment: The relative importance of interest rates and inflation can also change with the prevailing economic conditions. For example, in times of economic crisis, central banks might lower interest rates to stimulate economic activity, potentially impacting investors' strategies. We are in the process today of trying to navigate between controlling inflation through interest rates, and at the same time, trying to avoid a recession brought on by the same higher rates that will affect economic growth. This is the monetary unicorn known as the “soft landing”.

Asset allocation in a higher interest rate environment requires careful consideration of the macroeconomic landscape and an investor's risk tolerance and financial goals. Diversification remains a key strategy for managing risk across various asset classes.

Ultimately, the best asset classes in a higher interest rate environment will depend on the specific economic conditions and an investor's individual circumstances. The most important factor to consider in a portfolio strategy is to make sure that it is aligned with one's long-term goals and risk tolerance, ensuring a well-rounded approach to managing investments in changing interest rate environments.