

Easing and Excess

Now that the POTUS Twitter handle has changed hands, we no longer lose sleep worried how a late-night tweet will affect our portfolios. Unfortunately, our inability to get a good night's sleep is now caused by other issues, namely:

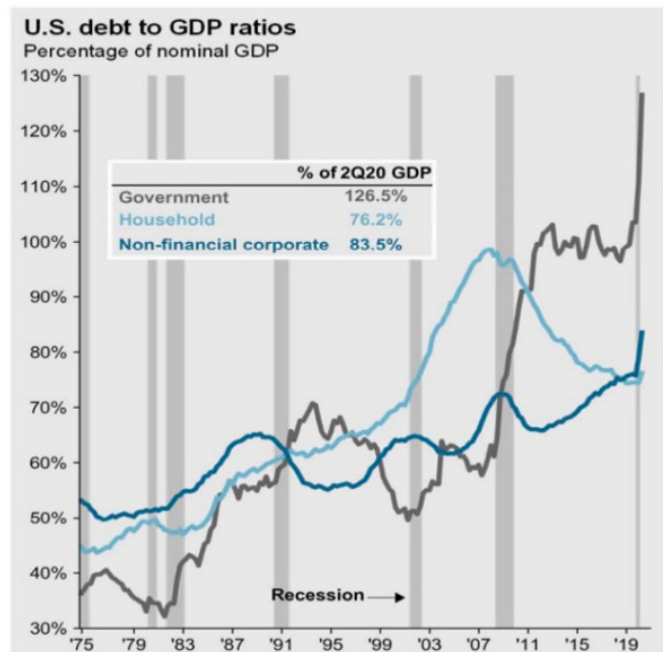
- **Growing U.S. Government debt,**
- The ability of the **U.S. Treasury to finance the debt,**
- The ability of the **Federal Reserve to keep both interest rates and inflation low,**
- The burgeoning **alternatives to holding the U.S. dollar,** and
- The current **very high valuations of both equities and bonds** despite these concerns.

Ever Increasing U.S. Government Debt

U.S. debt to GDP is currently at 130% of nominal GDP, exceeding the previous peak after World War II. Deficits and hence total U.S. Government debt will continue to climb as the estimated recovery to pre-pandemic levels of output will likely take 2 years.

U.S. Debt to GDP

As of December 31, 2020



Source: Guide to the Markets by JPMorgan, Q1-2021

GDP = Gross Domestic Product is the amount of goods and services produced within a given country.

Who will buy our debt?

To finance our deficit, the U.S. Treasury sells bonds and bills through the financial markets. Historically, the Treasury has relied upon individuals and institutions both in the U.S. and overseas to buy our debt. **Foreigners, including foreign governments**, have bought our bonds to recycle excess dollars received -since the U.S. runs a huge trade deficit with the rest of the world.

Since 2014, **foreigners have no longer been NET buyers of our debt** for two principal reasons:

1. Foreign countries are increasingly able to trade in their own currencies as their financial markets become deeper and more reliable. This is particularly true of China whose objective is to develop an economy less reliant on exports and more focused on their own consumers.
2. More importantly, the deficit driven increase in supply of U.S. Government bonds combined with very low interest rates has made our **debt less attractive to foreign buyers**.

To take one current example, a 10-year Chinese government bond has a 3.15% yield, far above the 1.1% yield on the corresponding 10-year U.S. Treasury Bond. In addition, the **Chinese economy is growing faster than in the U.S.**, and **China has a large trade surplus with the U.S.**

To attract foreign buyers, **the Fed could allow rates to rise more quickly**, but given the current level of government debt, higher rates **would lead to even larger deficits**. Just as importantly, higher rates on Treasury bonds would ripple through the financial markets and cause interest rates for all businesses and consumers to increase, **further dampening economic activity** at a time of high unemployment and business distress.

The **Federal Reserve**, as part of its program to keep interest rates at extremely low levels in the face of the pandemic, has chosen to step in and **buy the debt itself**. In 2020, Federal Reserve purchases were equal to 100% of all net bonds issued by the Treasury. In effect, the Fed swaps cash for the bonds, thereby significantly **increasing the money supply**. Such an increase can have two significant effects:

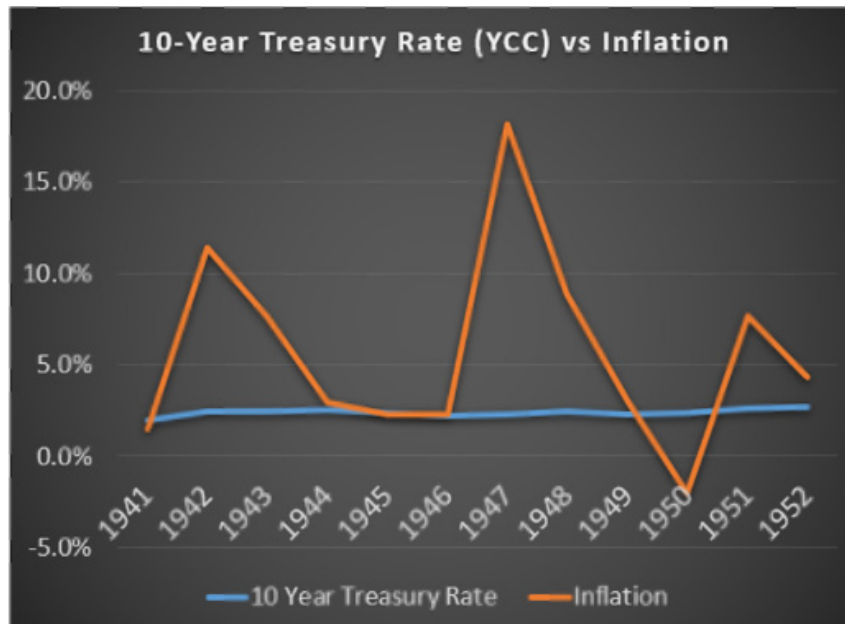
1. A decline in the value (price) of the U.S. dollar vs other currencies and
2. An increase in inflation, as the declining dollar makes imports more expensive, and as more dollars in general are available to purchase the same supply of goods and services.

Can the Federal Reserve keep buying U.S. debt without triggering inflation?

The slack in the global economy (an excess supply of goods and services), originally caused by globalization and increased use of technology and then magnified by the pandemic, has meant inflation remains low for now despite the dramatic increase in money supply.

What would the Fed do if inflation began to rise, given its stated policy of keeping interest rates low?

There is historical precedent for high government debt, high inflation, and low interest rates. In the 1940's, the Federal Reserve acted to control interest rates, a concept known as yield curve control (YCC), and inflation skyrocketed. The chart below shows a consistent 2.5% 10-year bond yield (controlled by Fed bond purchases), while inflation fluctuated. This policy negatively affected the purchasing power of U.S. citizens.



To provide perspective, after WWII, broad liquidity measures rose 65% above trend compared to 22% today. So, while liquidity growth today stands out relative to the last few business cycles, it has not neared the extremes of the post WWII period.

Alternatives to holding U.S. dollars

Bitcoin has seen a significant rise in investor interest and its value relative to the U.S. dollar. We can point to a number of ways investors look at using Bitcoin:

- As a store of value due to concerns about inflation and the purchasing power of the U.S. dollar
- As an alternative to gold for millennials who are attracted to its digital nature
- As a payment alternative for purchasing goods - increasing numbers of companies now accept Bitcoin
- For retail speculation

Many have predicted (and we would agree) in the next decade, there will be a redesign of world currency systems. Although we think the new money will likely be a digital bearer system, we don't think Bitcoin will be the ultimate answer.

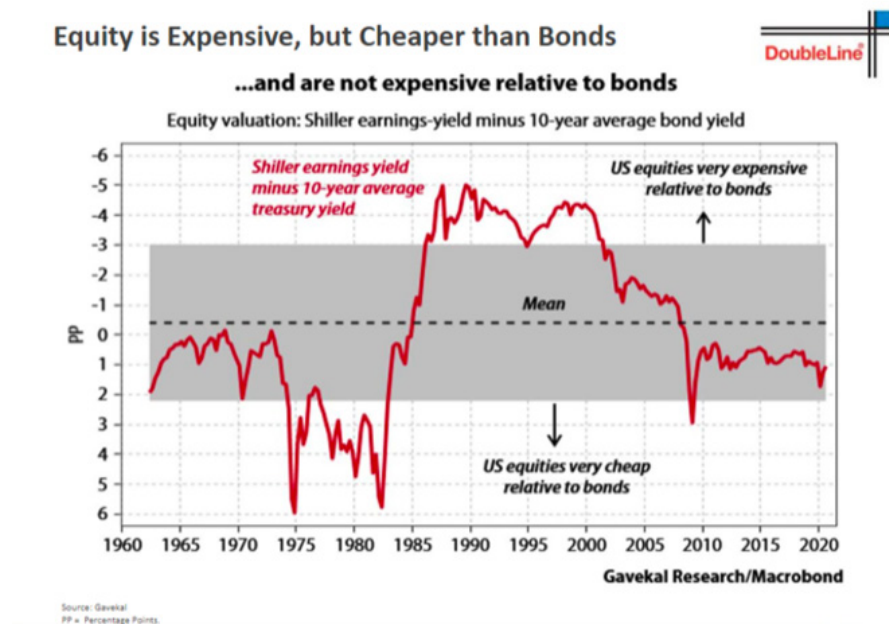
"The history of financial markets is the history of bubbles," said James Angel, Georgetown University finance professor. He notes that authorities could move to crimp the bitcoin rally if they start to get worried that it's becoming a threat. "Almost everybody who tries to start their own money does so in competition with a national currency, and it usually gets shoved aside by regulators."



High equity and bond prices

With all the money that the Federal Reserve is putting into the system, there are bound to be excesses. While many are concerned about bubbles in the stock market, the bond market also has risks and is unlikely to protect against equity sell offs the way it has in the past.

Jeff Gundlach published the following chart:



We think bonds will provide less of a buffer in the future given 1% yields and the Fed's stated commitment to inflation.

Going Forward

In June of 2020, we believed it made sense to consider the following:

- Higher equity allocations
- Smaller, lower duration fixed income allocations, with a dose TIPs
- A good helping of gold, and
- A dash of real assets and Emerging Market companies

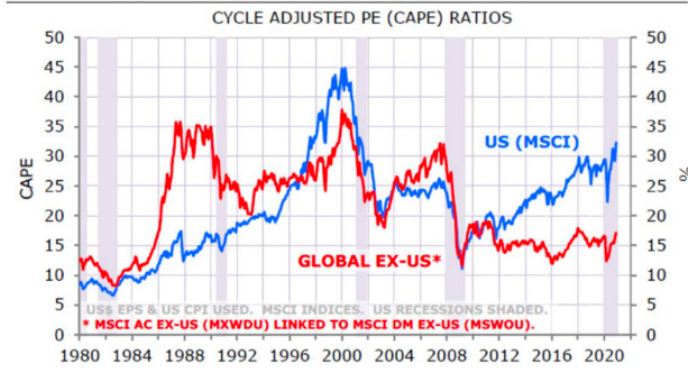
As we look to 2021, our views remain the same, but with an increased emphasis on equities outside the U.S., particularly emerging markets.

U.S. vs. Global ex-US Equities: CAPE



Exhibit 9

Global equities are half a bargain



Source: MSCI, BLS, NBER; Minack Advisors

MSCI ACWI Index - This market capitalization-weighted index is designed to provide a broad measure of stock performance throughout the world. It comprises stocks from 23 developed countries and emerging markets. You cannot invest directly in an index. CAPE = Cyclically Adjusted Price/Earnings (P/E).

Hopefully you haven't survived the challenges of the pandemic only to be done in by our dense missive.

Cheers!

Contact Us:

Lisa James

lisa@2xwealth.ingalls.net

212-269-7758

Lori Zager

lori@2xwealth.ingalls.net

212-269-7757

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2x Wealth Group is a team at Ingalls & Snyder, LLC., 1325 Avenue of the Americas, New York, NY 10019-6066. (212) 269-7757