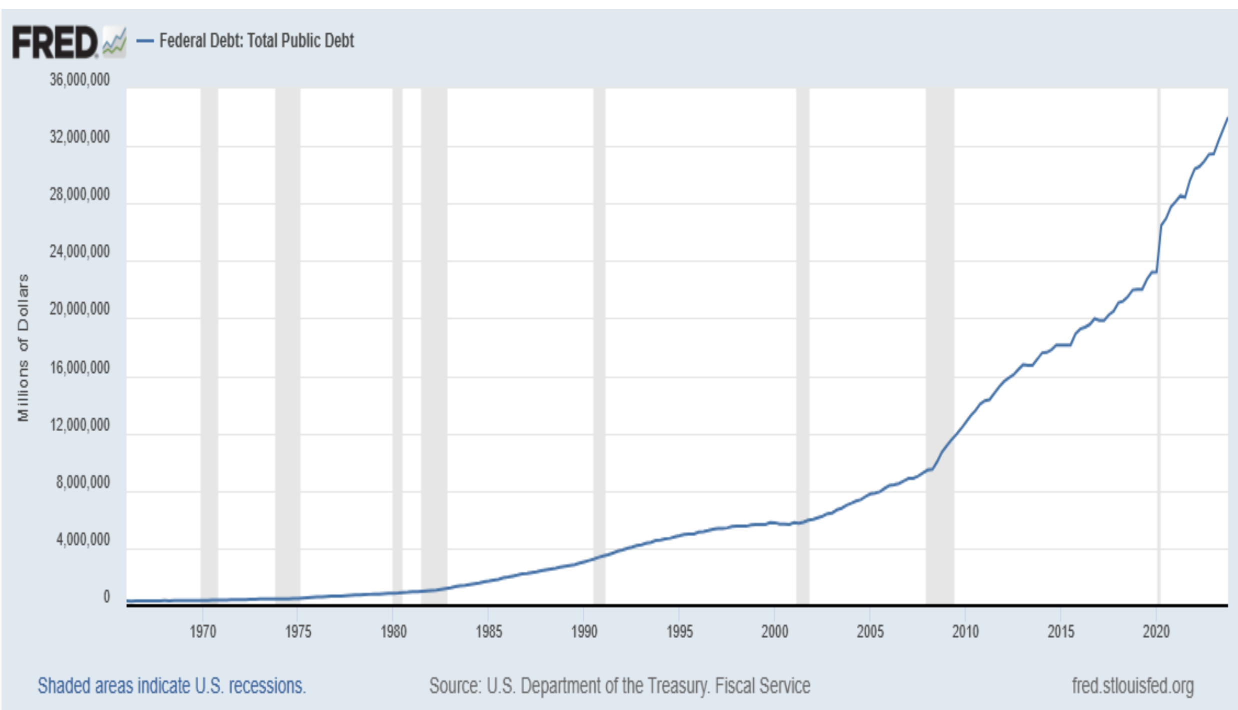
5/3/2024

Prepare for All Eventualities

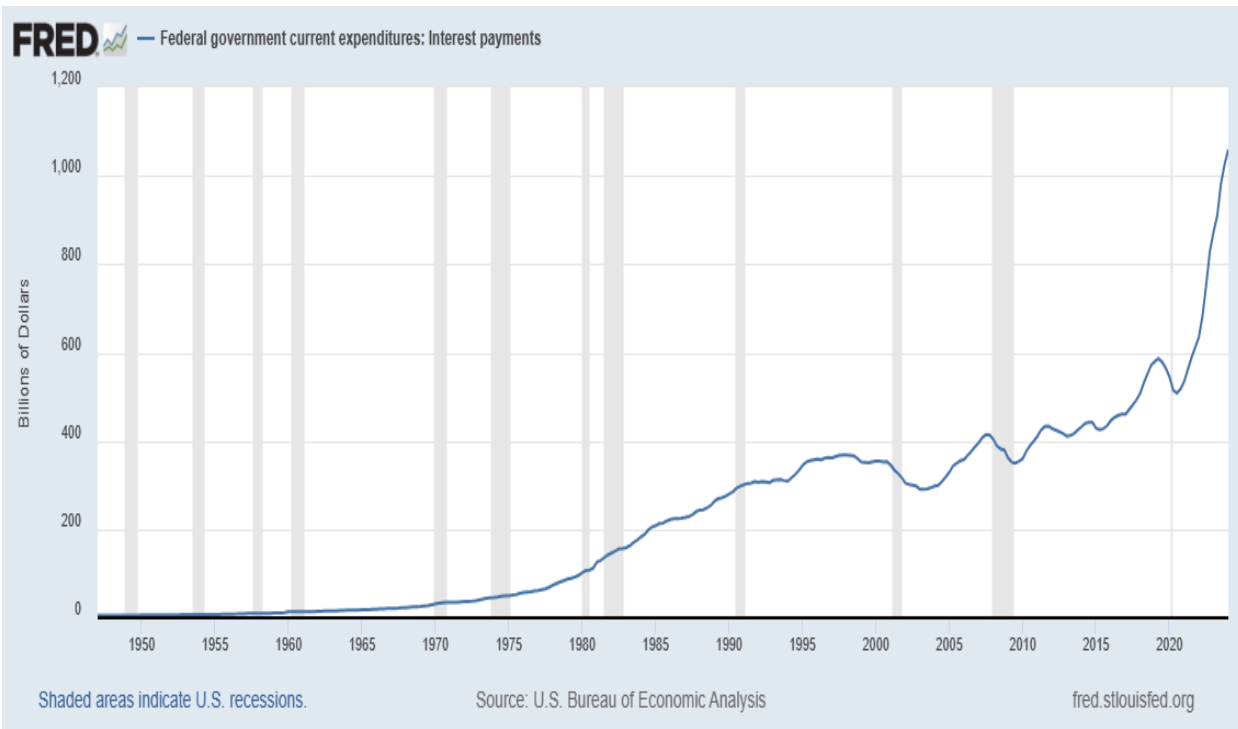
Robert G. Kahl, CFA, CPA, MBA
https://SabinoIM.com

In "The Gentleman" series on Netflix, a young British army officer named Eddie Horniman finds out that his father has died in England. When he returns home for the funeral, he is informed that he, rather than his irresponsible older brother, will inherit the estate and title of Duke. Unbeknownst to Eddie, his father benefitted from a joint venture with an illegal marijuana grow operation on their land.

Geoff Seacombe has been an employee on the estate for many years. When Eddie wishes to extricate himself from the illegal joint venture and asks Geoff for advice, Geoff responds, "Prepare for all eventualities." The Cambridge Dictionary defines eventuality as "something unpleasant or unexpected that might happen or exist in the future."



US Government debt has been riding an exponential curve upward since 2001 and is now at $34.7 trillion. The budget deficit for 2024 is forecast to be 6% of GDP, at a time when the economy is doing relatively well. When government debt/GDP and interest rates were lower, there was little concern about the government debt level. However, we are approaching a debt/GDP level accompanied by higher interest rates that is cause for concern. Below is a graph of annualized interest expense of the US Government which reached $1.06 trillion as of the end of the first quarter 2024. Federal government interest expense is expected to continue rising at a rapid rate as the US Treasury refinances maturing debt at higher interest rates. By comparison, federal government tax revenue for 2023 was $4.83 trillion.



We have now reached the point where a crisis is looming for US Treasury debt within the next three years. There are three possible outcomes:

1) Investors avoid US Treasury debt due to a decline in creditworthiness and the Federal Reserve becomes the primary buyer. This would accelerate the money supply growth and lead to an increase in the rate of inflation and eventually hyperinflation if corrective action is not taken.

2) The Fed does not intervene as investor demand for US Treasury debt declines. This leads to a default on some US Treasury debt and an attempt to restructure debt to reduce the debt burden. This scenario would be highly disruptive because US Treasury debt is widely held by many institutions, including the Federal Reserve, the FDIC,

commercial banks, the Social Security Trust fund, and others.
3) Congress and the President decide to exercise fiscal responsibility and dramatically reduce spending and raise taxes to reduce debt and interest expense to a manageable level. Though painful, the objective would be to avoid the more unpleasant alternatives of hyperinflation or default.

The three scenarios above are listed in order of most likely to least likely, based on my subjective opinion. The third scenario seems to have a low probability at this time, but stranger things have happened. Different asset categories can be expected to perform well or poorly under the different scenarios.

When I talk with other investment advisors, nearly everyone recognizes the potential danger of a fiscally irresponsible government, but portfolio allocations reflect a presumption that there has not been any fundamental change in the economy during the last 30 years. While I will not attempt to provide forecasts of investment returns for the three scenarios at this time (or other scenarios based on geopolitics), I will be mindful of developments and adjust portfolios accordingly.

If you have any questions or comments, please contact me.

Sincerely,
Robert G. Kahl
CFA, CPA, MBA