

# MARKET COMMENTARY

## HOW DEFICITS IMPACT YOUR PORTFOLIO



**Imagine this: The U.S. economy had a stellar year last year, outperforming Europe with a robust 2.5% growth rate. This is a far better performance than almost anyone imagined. It was better than most economists, pundits, and forecasters thought possible a year ago. Yet, not only did the economy grow far better than expected, but investors got hooked on risk again.**

Novel AI technologies captured investor imaginations, leading the tech-heavy Nasdaq Composite Index to trade at a near-record 60% premium to the S&P 500 based on enterprise-value to cash flow multiples (Nasdaq now trades at 24.3x versus S&P 500 at 15.2x).

However, what's hidden beneath these impressive numbers is a question that's been on everyone's minds lately – did this economic success come at the expense of ballooning deficits? This week, we're diving deep into the world of deficits to uncover what it all means for your investment portfolio.

### **SOARING DEFICITS (AND DEBT)**

Government deficits have been on a wild ride since the pandemic hit. In the five years before COVID-19, the deficit averaged just 3.5% of the economy's size. But in the four years since the pandemic, that number skyrocketed to an eye-popping 9.7%, with 2023 still ringing in at nearly 6%. Tax revenues did increase (from 16.2% in 2019 to 18.2% in 2023), but spending surged even more (from 21% in 2019 to 24.2% in 2023).

To fund these deficits, the U.S. had to borrow a jaw-dropping \$11 trillion. Helpfully, the Federal Reserve (Fed) stepped up and bought a whopping \$3.5 trillion (net) of that debt between 2020-2023. The public stepped up for the rest, shelling out \$7.5 trillion. Fast forward to today, and the U.S. federal debt is now \$34 trillion, 47% higher than pre-pandemic levels (Chart A, left on page 4). Over the last four years, the U.S. government borrowed almost \$3 trillion annually to keep the deficit train chugging.

But here's where it gets tricky. Servicing that debt is no walk in the park anymore. Interest rates aren't near zero

anymore, and the Fed isn't inclined to buy more bonds soon. In 2023, interest expenses on the debt soared to a staggering \$883 billion, gobbling up 3.4% of GDP. That's pretty much the entire deficit that existed in the five years leading up to the pandemic (which was only 3.5%).

And the Treasury is in a tight spot, too. They found that long-term interest rates could spike without the Fed buying the mountain of bonds they issue. This is what happened last fall when 10-year Treasury rates hit 5%. A fix was for the Treasury to issue more short-term T-Bills (fast approaching 18% of debt), but this strategy is now pushing the government's funding into the precarious position of too much exposure to potentially volatile short-term rates (Chart A, right on page 4). So, we imagine future issuance will evolve toward longer-dated bonds, potentially throwing a wet blanket on the "return to low rate" scenario.

And we're not done yet. The trade deficit, that thorny issue that never seems to go away, is still very much in the picture. In 2023, it stood at nearly 3% of GDP, a hefty \$217 billion. Sure, it's less than the deficits we saw in 2022 and 2021, but it's still there, despite all the efforts to kick-start a U.S. "manufacturing renaissance."

### **A TRIP DOWN MEMORY LANE**

Now, let's rewind the clock to a different era. Back in the 1980s, the concept of running continuous fiscal and trade deficits was relatively new. Economists created a new term, the "twin deficit," to describe the situation of persistent fiscal and trade deficits. The term was made up because as recently as the 1960s, there was no significant "twin" deficit to be found. Why? That was the era of the Bretton Woods system, a time when most countries

pegged their exchange rates to the U.S. dollar, and the dollar was convertible to gold. The system acted like an automatic financial pressure release valve that kept trade imbalances in check.

Moreover, the 1960s and 1970s were a period of more conservative government finances. Policymakers played it safe when it came to running large deficits, and there was a strong bipartisan agreement on the importance of fiscal responsibility. Fast forward to today, and things look a bit different. Ideological shifts and demographic changes have nudged spending priorities, and tax initiatives aren't at all easy to sell to the American public as a way to pay for vast amounts of spending.

Chart B on page 4 shows today's "twin deficit." Recently, the "twin deficit" has been running between a whopping 5-10% of GDP (\$1.5 to \$2.5 trillion year after year for several years now).

### **THE MODERN TWIST ON DEFICITS**

Despite fears about ballooning federal debt, some economists argue that deficits aren't all doom and gloom. After all, one party's deficit can be another's surplus. In other words, if the government and foreign sectors run deficits, the private sector can accumulate surpluses. A "twin deficit," where both the government and foreign sectors are running big deficits, means the private domestic households and industry can receive big surpluses (savings and profits).

But, and there's always a but, this process can also sow the seeds of financial instability. Overconfidence can lead to reckless borrowing, and depending on speculative gains, can make the system vulnerable to shocks. It's a

bit like walking a tightrope, where the wrong move could spell trouble (i.e., Hyman Minsky's Financial Instability Hypothesis).

### **NAVIGATING THE DEFICIT MAZE**

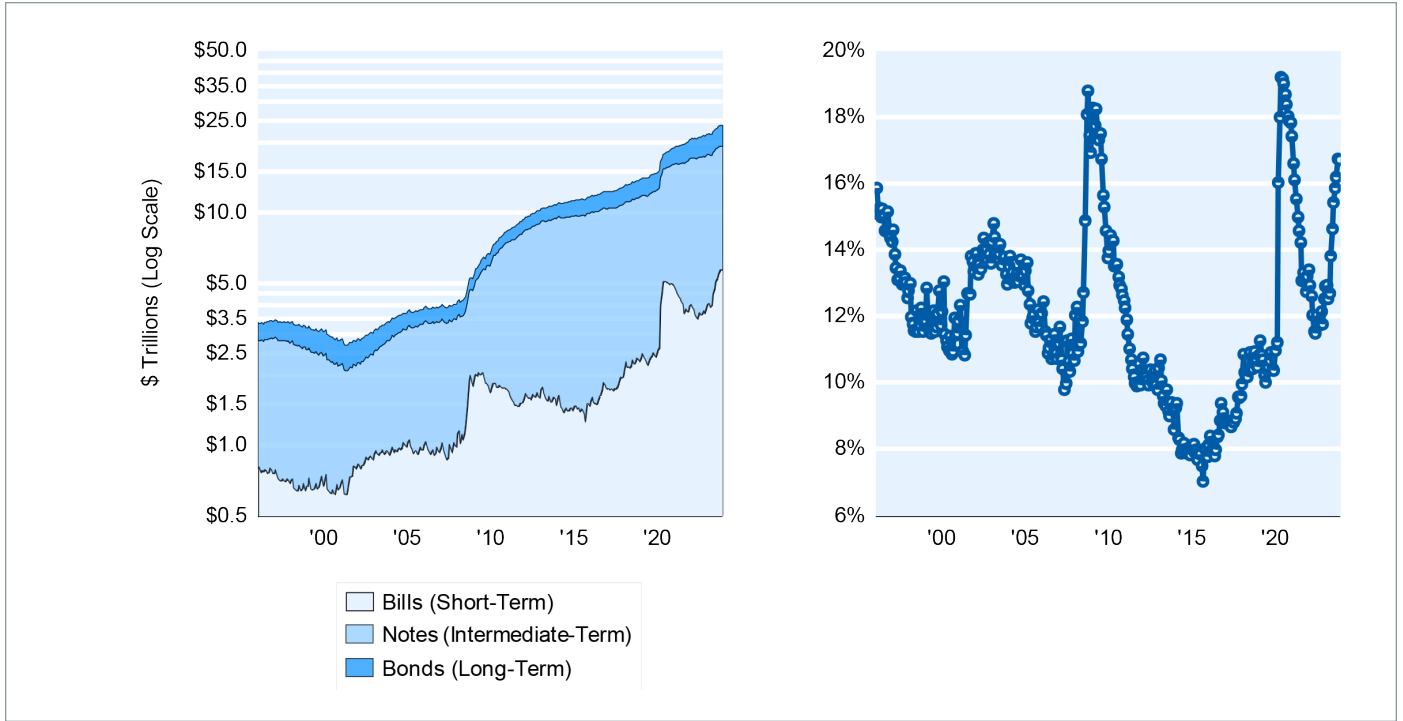
So, what does all this mean for your portfolio? Well, it's a mix of opportunities and risks. On the one hand, government and foreign deficits can be seen as surpluses to the private sector. For investors, that means potential opportunities to capitalize on these deficits by investing in businesses that benefit from an expanding economy. However, the road is not without its bumps, as deficits also carry the risk of financial instability.

So, here's our game plan: we're putting the spotlight on quality. Companies that are resilient, adaptable, and predictable are the building blocks of WCA equity portfolios. They have low debt, profitable assets, and steady businesses, which can help weather unexpected twists and turns in the financial world.

At Washington Crossing Advisors, our strategy revolves around these quality companies. We aim to build portfolios that not only deliver positive returns but also offer protection against the unexpected. So, while the U.S. economy appears to be on the rise, we're keeping our focus on quality to ensure our portfolios stand the test of time.

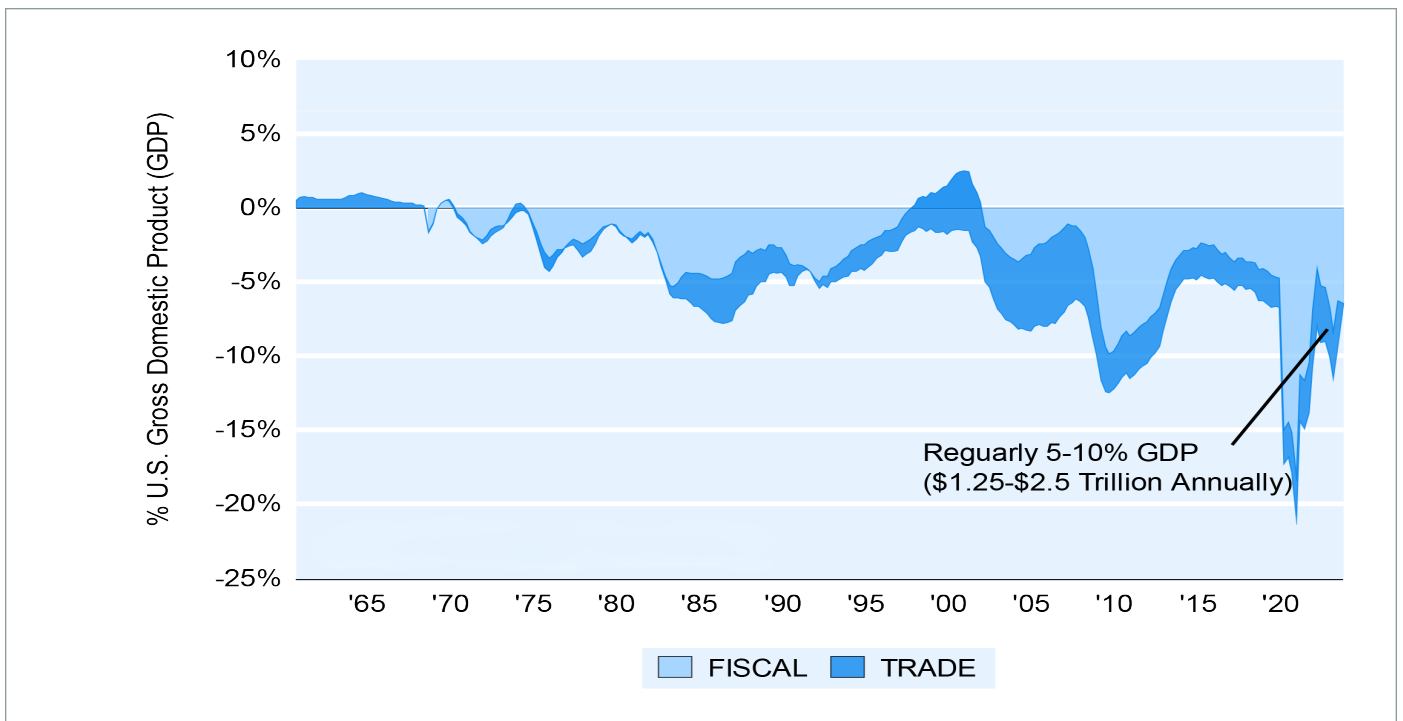
**CHART A | U.S. PUBLIC TREASURY DEBT / U.S. TREASURY BILLS (% TOTAL)**

Source: U.S. Treasury



**CHART B | "TWIN" DEFICITS AS PERCENT OF GDP FEDERAL GOV AND U.S. TRADE COMBINED**

Source: U.S. Treasury



**WCA Fundamental Conditions Barometer Description:** We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a “barometer” for changes in fundamental conditions.

**Index Descriptions:** WCA Quality Indices are based on Washington Crossing Advisors’ quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

**Standard & Poor’s 500 Index (S&P 500)** is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.

**S&P High Beta Total Return Index** is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.

**S&P Low Beta Total Return Index** is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher-quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity investments are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors to varying degrees. Fixed Income investments are subject to market, market liquidity, issuer, investment style, interest rate, credit quality, and call risks, among other factors to varying degrees. Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark. A forward contract is a type of customizable derivative contract that involves two parties who agree to buy or sell a specific asset at a set price by a certain date in the future. Forwards are similar to futures contracts, but they are made over the counter (OTC) and settle only once, on their expiration date.

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