The Long & Short of It

Quarterly Newsletter
Second Quarter 2020

In a time of extreme divisions, 2020 is uniquely odd for such an even number. Between the growing obsession with left and right, from which few benefit other than the media and political parties, we have witnessed a record stock market drop in the first quarter followed by a record rise in the second; near-negative interest rates, concurrent with unprecedented monetary and fiscal stimulus; and a global pandemic all the while. Two things seem painfully evident: 1) nuance is dead, if not dangerous to engage in; and 2) attention spans remain short.

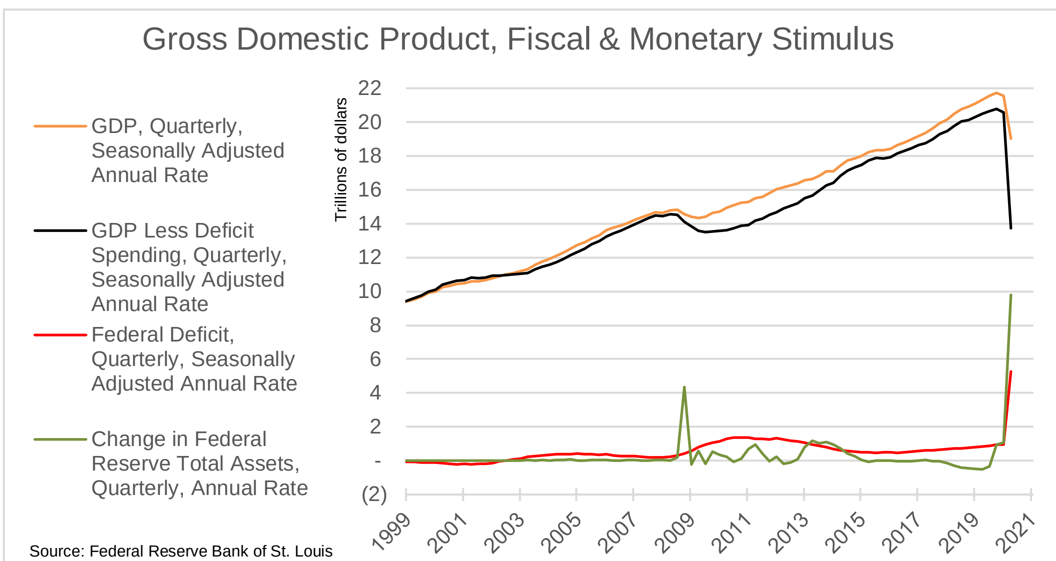
Nuance

Let's step back and take a 20,000-foot view of our economy starting with Gross Domestic Product (GDP). On July 30, 2020, GDP for the second quarter will be released. If we use the current estimates provided by the "GDPNow" tool of the Federal Reserve Bank of Atlanta, a 30-40% annual decline is expected. That's a rather shocking number. Yet in actuality, the economy (GDP) will have only declined by about 8-10%.

Why the disparity? The answer lies in the government's calculation methodology, which measures the change from the prior quarter and extrapolates it to an annual rate of change. To give you a sense of how objectionable this is, if an investment firm took one quarter's return of 10% and annualized it to claim a 40% return, financial regulators would rightfully waste no time in shutting them down. Yet this is considered acceptable financial reporting by our government.

US Department of the Treachery

Now that you are primed with that head-scratcher, let's look for some nuance in the numbers. This concerns the degree to which the federal government borrows money (e.g., issues Treasury debt) to support our economy, and who purchases that new government debt.



Quarterly deficit spending peaked at about $345 billion in the first quarter of 2011, declining to approximately $115 billion in the third quarter of 2015. It had grown back to roughly $235 billion by the time the pandemic hit. For the second quarter of 2020, deficit spending is estimated to have surged to an extraordinary $1.2 trillion (a very rough guess at this point). In Chart 1, if we focus on GDP less federal borrowing and spending (black line), we see that the economy (GDP) would have actually dropped not by 10% but by roughly 33% in the second quarter of 2020 if it weren't propped up by the ballooning deficit.

By borrowing and spending, the government moves future consumption into the present to avoid risk that comes with a dramatic slowdown in the economy. But experts tell us this risk does not simply go away; it merely gets moved around or postponed. Like an addict, our economy's need for more and more of the borrow-and-spend "stimulant" continues to grow. Funding the addiction, i.e., allowing citizens to feel safe in the short run while the problem of our national debt grows, is popular these days in the halls of academia. But even those in the hallowed halls will mostly agree that it is treacherous business if the deficit spending is paid for with money printed by the government as can be seen in the current coordination between the what we refer to with a wink and a nod as the US Department of the Treachery and the Federal Preserve.

The Federal Preserve

With all that borrowing, the Federal Reserve increasingly does far more than "stand ready" to help if needed, moving well beyond its inflation and employment mandates. It has purchased enough Treasury debt to provide liquidity to tightening markets, fund said debts, and preserve stability…for now. If citizens in the past worried about the "borrow and spend" of government, it was never on the scale it is today, nor did it involve the Federal Reserve being the primary buyer of US debt.

Change in Assets of the Federal Reserve (blue) and Price of Gold (gold)

Today's shell game of the Fed preserving the economy through its purchases of Treasury debt and paying for government spending is not sustainable. Inflation is probable with the prices of gold and gold mining stocks likely to rise. As our fiscal and monetary institutions shift from being too slow to solve problems to being so nimble as to be the key drivers of economic activity, they risk undermining their perception of stability and become viewed as problematic rather than merely slow or weak. In the end, fiat money and credit systems depend on confidence. An environment where structures and systems are being attacked is an interesting (and questionable) time to experiment with these foundational institutions.

Tomorrow Never Dies

By maintaining exposure to the common stock of industry-leading companies with clean balance sheets, investors can preserve and grow their purchasing power over time. Don't be deceived by the need to swing from the rafters with the latest hot stock idea. "Boring" companies often have mergers and acquisitions (M&A) departments that constantly seek new technologies and product ideas to keep them modern and competitive. These companies also have significant expertise in their respective sectors of the economy, cash flow, distribution channels, and an existing customer base. The end result is a supply of "new ideas" from within their own ongoing operations, with their M&A and R&D departments serving as de facto venture capital teams.

In the end, like the virus, the economic disruption will eventually, mostly, pass while leaving some scars and things will return to a place that feels somewhat like normal. Equities are volatile but they provide both wealth creation and a durable store of value due to their ownership of the means of production. Cash and bonds may provide greater stability but will not protect against a declining currency undermined by ballooning federal deficits and money creation. In a treacherous world, it is safer to be in the kitchen despite the heat.

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