The Long & Short of It
Quarterly Newsletter
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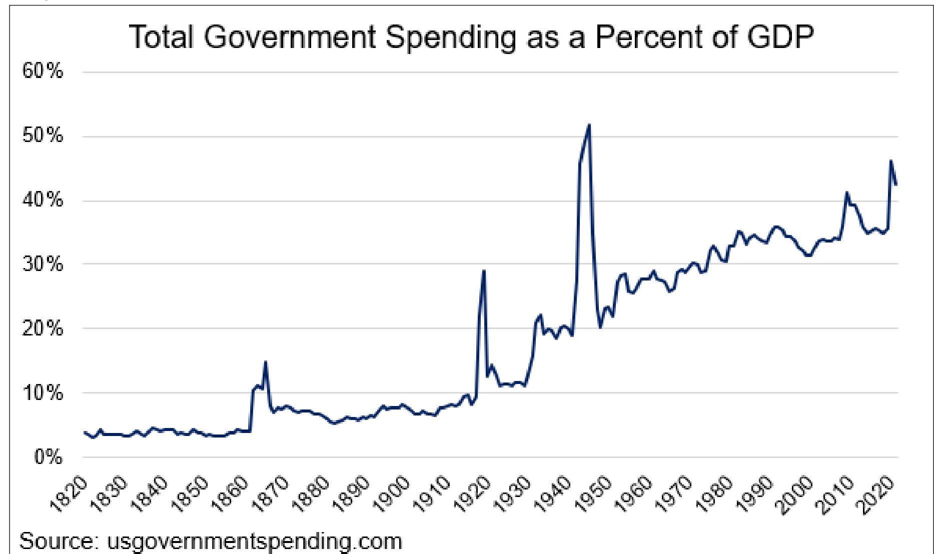
The Growing Size of Government: Why It Matters for Investors

The portion of economic activity attributed to governmental agencies and activities has grown with constancy since the founding of the United States. In 1850, combined federal, state, and local spending accounted for 3.4% of gross domestic product (GDP). By 1900, it increased to roughly 7.6%. Post-World War II saw a rise to 23.5% in 1950 and 31.5% by 2000. Government spending as a percentage of GDP is now expected to average 40% over the current decade.



Modern monetary theory argues that debt doesn't matter and there are no spending constraints on a government that produces its own fiat currency.[1] Print the money and spend it, say the advocates. Who cares, right?

Not so fast. Since 2010's seminal work by Reinhart and Rogoff[2], numerous researchers from the Carnegie Endowment and the International Monetary Fund to the Council on Foreign Relations have said otherwise. In May 2024, the Congressional Budget Office (CBO) stated that "rising debt will slow income growth by an increasing pace over time."[3] The researchers argue the larger the government's share of GDP, the slower the growth of real income per capita. Slower economic growth limits real wealth creation and, by consequence, limits the real return potential of equities both private and public.

Given its outsized impact on spending, the government's very existence seems to rely on its ability to manage the outcome of the economy and, in particular, financial markets in the short run. This codependent system will likely remain in place as long as the US dollar remains the world's reserve currency and/or markets do not object to the government's heavy hand in a way in which the government can't control. The tenuous balancing act sets the stage for market risk and currency risk to rise, resulting in more volatility for equity investors and the possibility of unrecoverable losses of purchasing power for cash and fixed income investors.

Today's Environment

The future is uncertain. But you would not know this from the market's pricing these days. The overstimulated economy is cooling off and inflation is approaching targeted levels. The US stock market's price level reflects a high probability of a soft landing, a topic widely discussed and optimistically expected by many. Despite the fact that soft landings are arguably either extremely rare or nonexistent, no one wants to be a nattering nabob of negativity, so benign expectations persist.

In the *Wall Street Journal's* article "The Fed Aims to Repeat Greenspan's 1990s Masterpiece" published on September 20, 2024, the subheading states: "The 1995 cuts helped lay the groundwork for a soft landing and

the late '90s boom years." Recession was likely not imminent in 1995, but the rate cuts laid the groundwork for the dot-com mania of the late 1990s and the 2000-2002 bear market.

As the article points out, Greenspan was able to drop the federal funds rate a mere -0.75% to reach what was then thought to be a "neutral interest rate." Today, after the Federal Reserve has already moved by an aggressive 0.50%, the current rate of 4.75-5.00% remains 1.25-2.50% above the 2.5-3.5% that is considered neutral. At the rate of a quarter-point drop at each Federal Reserve meeting, it will take until May 2025 to reach the high end of neutral and until December 2025 to get to the low end of the estimated neutral range. To reach truly accommodative monetary policy, the Fed will have to get below that (think 2026?). Even then, there remains the one- to three-year lag between the implementation of monetary policy and its main impact. Restrictive monetary policy's impact should be around for a while.

For example, interest rates on new loans remain expensive when compared to the interest rates that the average debt holder is currently servicing. Today's borrowers cannot afford to move from their house or refinance their business loans, as those new loans will price at a higher rate. So monetary policy remains tight and should continue to have a tightening effect for the next 2-3 years.

As for us, we are not gluttons for punishment or suffering. We like economic expansion and bull markets as much as the next fiduciary. But there is something necessary and healthy about a business cycle. It allows resources to go to a better use. Counterproductive capital allocations (such as bubbles and manias) are repurposed, as are poorly capitalized or managed enterprises (which get shut down or sold to better firms). This liberated capital is redeployed toward well-capitalized, better ideas with more skillful management. This increases real growth and incomes, which seems a better outcome in some ways when compared to inflationary growth caused by a government trying to avoid a business cycle. More importantly, as an investor, it seems unwise to be unprepared and not seek to take advantage of the business cycle.

Whirlpool or Calm Seas

The surge in fiscal deficit spending while monetary policy impacts were lagging has kept the US economy afloat for the last two years. The source of the rise in economic activity and interest rates is well known: Congress's fiscal spending. The scale is staggering. Normal, sustainable levels of economic activity are well below today's levels. Seemingly unaware of the ongoing inflation, Congress borrows and spends, producing deficit levels designed for severe recessions and entirely at odds with the monetary policy of the last two years.

For the government to be borrowing and spending like drunken sailors, running up the nation's debts while the Fed tries to steer the ship to calmer, safer waters, is colossal irresponsibility on the part of policymakers. We believe it will not end well. Cycles can take a long time to work themselves out, and the fiscal spend has made this economic cycle/bull market last an unnaturally long time. But yellow lights are flashing. Recent signs of accelerating economic weakness include: rising unemployment claims, slower job creation, declining consumer sentiment, housing not responding to lower interest rates, slowing manufacturing activity, and increasing corporate debt defaults. For the last three months, the Consumer Price Index (CPI) and Personal Consumption Expenditures Price Index (PCE) have run at an annualized rate at or below the Fed's 2.0% target.

Although both presidential candidates promise more government programs (a.k.a. "spend more now") and Congress rarely objects to that spending in the face of reelection, voices encouraging fiscal responsibility are growing. If monetary policy and a slowdown in the growth of spending result in a recession, we will expect complaints of "AUSTERITY!" by one side about the suffering imposed on Americans by the other side. Next, government will open the floodgates of money and pump-up liquidity at levels previously unimagined. The game will continue until the markets object so stringently that the Fed cannot manage it. In some ways, the market's protest may have already begun. Year to date, while the S&P 500 has risen a healthy 22%, gold and silver bullion have risen 28% and 33% respectively. Stocks celebrate as inflation declines toward targeted

levels, but precious metal investors are betting inflation will eventually overshoot and drop below target and require extraordinary accommodation by the Fed that leads to devaluing the dollar.

Tactics

Periods of excessive inflation, like that of Weimar Germany, have shown that owning the means of production (i.e., equities) remains the best method to preserve purchasing power and to create wealth in the long run. However, if the considerable volatility of equities becomes too much to bear and one must "Balance" your portfolio, there are low-correlation investments that profit from inflation and deflation that we find preferable to cash and intermediate bonds.

Knowing what these holdings are and when to lean into or away from them is what Robinson Value Management and its predecessors have worked toward for over 20 years.

At Robinson Value Management, we develop and implement investment strategies with a focus on risk management and mitigation at multiple levels, from individual security analysis to taking advantage of the macroeconomic environment. While we continue to employ traditional risk-aware, bottom-up fundamental security analysis for our stock and bond portfolios, we also analyze macro-level financial and capital market responses, especially those resulting from government policy-making and execution. In other words, we pay particular attention to the government's influence on both company-specific and systemic risk when we build and manage client portfolios.

Chart a Course

Most importantly, we believe that investors should be positioned to survive, if not thrive, in the face of the risks and volatility that result from our oversized government's large footprints and unfettered access to capital markets. If you would like to continue this discussion of investing to benefit from the activities of government, please call or email us.

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[1] Petis, Michael. "How Does Excessive Debt Hurt an Economy?". Carnegie Endowment for International Peace. February 8, 2022.
[2] Reinhart, Carmen M. and Kenneth S. Rogoff, "Growth in a Time of Debt" *American Economic Review: Papers and Proceedings 100 (May 2010), 573-578*.
[3] Congressional Budget Office. "The Long-Term Budget Outlook Under Alternative Scenarios for the Economy and the Budget." May 28, 2024.

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