Richard Bernstein Advisors

Pactive® Approach to Investing

Insights

October 2024

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an investment manager focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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Fade the Election Part 2: Debt & Deficits

In "Fade the Election," we highlighted that Presidential elections have not been as important to the financial markets as many observers claim. Whereas pre-election analyses are abundant and fully range from ebullient to apocalyptic, historical returns show that Presidents have very little impact on the overall stock market, on sectors, and on asset allocation.

Some of the historical returns are quite opposite to electioneering hyperboles. For example, who would have guessed that Energy would be the best performing sector during the Biden administration or that Emerging Markets would outperform US small stocks during the Trump administration?

Debt, Deficits, and Decay

The most common questions we've been asked as the election approaches are generally about the Federal debt and deficits. We first wrote about this issue in 2018 ("Debt, Deficits, and Decay"), and the conclusions of that report remain important:

- Neither party can claim to be fiscally responsible because both have significantly contributed to the US deficit and debt problems.
- The deficit and debt problem started during the early-1980s, and there has been only one administration that showed overall fiscal accountability: the Clinton administration engineered a budget surplus.
- There's nothing inherently wrong with debt. However, the US has a significant asset/liability mismatch, i.e., long-term debt has been used to finance spending and tax cuts that have had limited long-term benefits or whose benefits have "leaked" abroad.
- Long-term debt should have been more productively used to finance long-term assets such as infrastructure, which the country now woefully needs.

It's Debt/GDP that matters

The famous National Debt Clock, an electronic billboard that counts the ever-increasing US national debt, continues to tick away close to RBA's New York offices. It's an excellent attention-grabber, but it is more fear mongering than accurate analysis.

Larger companies tend to have larger absolute amounts of debt, but they also have larger asset bases. A large cap company is not necessarily riskier than a small cap company simply because the larger company has more debt. Debt/total assets or debt/equity are typical scalers for such comparisons.

Similarly, a larger economy is not necessarily riskier than a smaller economy simply because the larger economy has more debt, so one should scale debt by nominal GDP. It is natural for debt to grow simply because the overall economy grows, so Debt/GDP is more informative than simply total debt.

The Debt Clock might be more fun because a Debt/GDP clock would be very boring in a 5- or 10-minute time span.

The modern history of Debt/GDP

Chart 1 is a historical view of US debt/GDP by Presidential administrations. It shows that today's claims regarding which party is more fiscally responsible are largely inaccurate. Here are several points that get buried in today's name calling and accusations:

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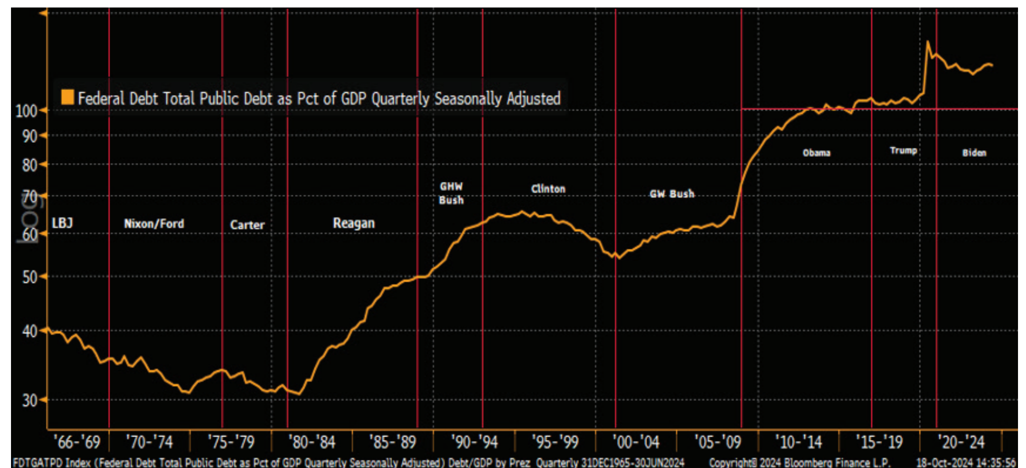
1. Debt/GDP has been secularly rising for 40 years, i.e., since the early-1980s.
2. Debt/GDP grew substantially through three Presidential terms: Reagan, GHW Bush, and Obama.
3. Debt/GDP has crossed the 100% threshold (i.e., Federal debt equals nominal US GDP) and stayed above that level for each of the last three Presidents (Obama, Trump, and Biden).
4. Some are currently concerned about the potential for the US to "inflate away the debt" as though lowering Debt/GDP by increasing inflation would be a new and suspect strategy. However, Debt/GDP fell during the three Presidents immediately prior to 1980 (LBJ, Nixon/Ford, and Carter) largely because inflation spurred nominal GDP growth.
5. The only time Debt/GDP fell without inflating away the debt was during the Clinton administration.

Neither party can accurately lay any claim to historically being fiscally conservative despite both boldly stating that electing their party will provide the only route to fiscal rectitude.

CHART 1:
US Debt/GDP
(Dec. 1965 - Jun. 2024)



Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.

The "day of debt reckoning" was 13 years ago!

Many investors worry about a looming "day of reckoning" for US debt. They fear the US's fiscal imprudence will eventually force a sudden and dramatic repricing of US debt. The reality is the day of reckoning occurred 13 years ago!

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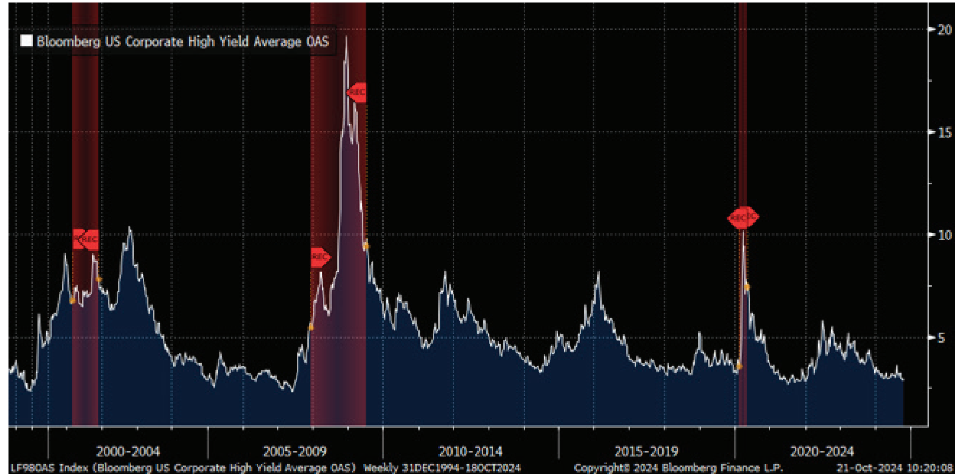
Lower quality credits typically offer higher interest rates to compensate investors for the higher risk of default. For example, investors fully expect "junk" bonds to have higher yields than do higher quality bonds.

Chart 2 shows the history of Corporate High Yield Bond spreads versus Treasuries. Spreads are always positive (i.e., junk bonds always yield more than Treasuries), and spreads widen when corporate cash flows come under pressure like during a recession when the risk of default rises.

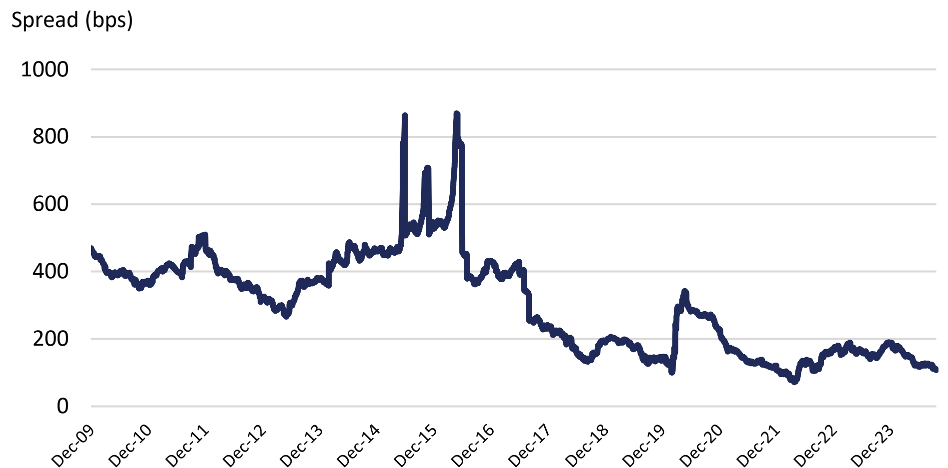
CHART 2:
US High Yield Bond Spreads vs. US Treasuries
(Dec. 1994 - Oct. 18, 2024)



Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.

Lower quality municipal debt is priced similarly to lower quality corporate debt in that the asset class always sells at a premium yield to Treasuries. Chart 3 shows the High Yield Muni spread through time.

CHART 3:
High Yield Muni Spread
(Dec. 31, 2009 - Oct. 18, 2024)



Source: Bloomberg Finance L.P., ICE® BofA

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Fixed-income markets consistently reward investors and penalize borrowers when borrowers' balance sheets and cash flows are weaker, and such risk premiums exists regardless of whether issuers are private or public entities.

Although ignored by most bond investors, the same risk premium has applied to US Treasuries. For a long time, US Treasuries were AAA rated, but they were downgraded in 2011. Bond market theory would suggest that US Treasuries should have provided a risk premium yield versus other AAA-rated sovereign debt after that downgrade, and that is exactly what has happened.

Chart 4 shows the yield spread between US Treasuries and German Bunds, which are AAA rated. US Treasuries and German Bunds traded with comparable yields for many years. German bunds were considered riskier during reunification (i.e., East Germany and West Germany again became one nation), but the two bonds generally traded within 150bps yield spread.

However, US Treasuries have consistently sold at a risk premium yield since the US downgrade in 2011. At the peak, Treasuries yielded more than 275bp more than German Bunds! (For comparison, the current spread between US High Yield Bonds and US Treasuries is 286bp.)[1]

This shift to a consistently higher risk premium went largely unnoticed because the absolute level of US interest rates was so low, but US yields likely would have been even lower had the US not been downgraded.

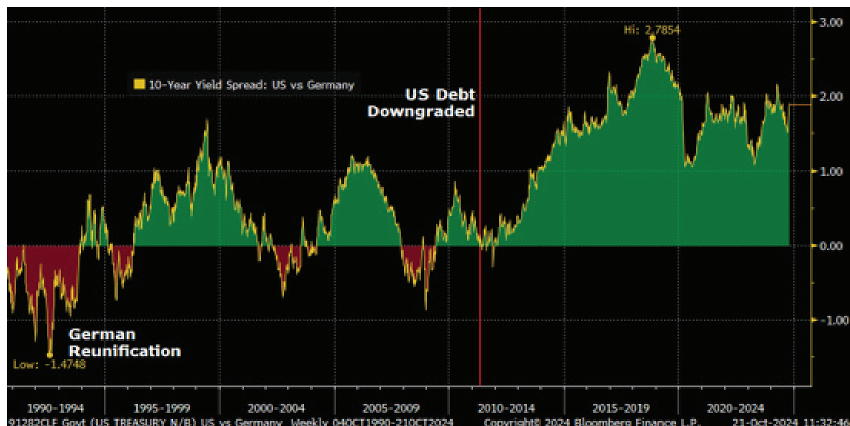
Because all US debt is priced off Treasury yields, the US debt downgrade made debt obligations more expensive to US borrowers. US borrowers in mortgages, bank loans, municipal bonds, corporate loans, student loans, and leases all paid higher interest rates than they would have if the US government had acted with more fiscal responsibility.

Whereas today's common political refrain is a day of debt reckoning is coming, the reality is that day occurred 13 years ago, and the US economy has been insidiously penalized ever since.

CHART 4:

US vs. Germany: 10-Year Yield Spread

(Oct. 4, 1990 - Oct. 21, 2024)



Source: Bloomberg Finance L.P.

[1] A similar spread analysis can be done using nearly any AAA rated sovereign debt. Currently, the following countries are rated AAA: Australia, Canada, Denmark, Germany, Liechtenstein, Luxemburg, Netherlands, Norway, Singapore, Sweden, and Switzerland.

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Fade the cries of a financial apocalyptic abyss

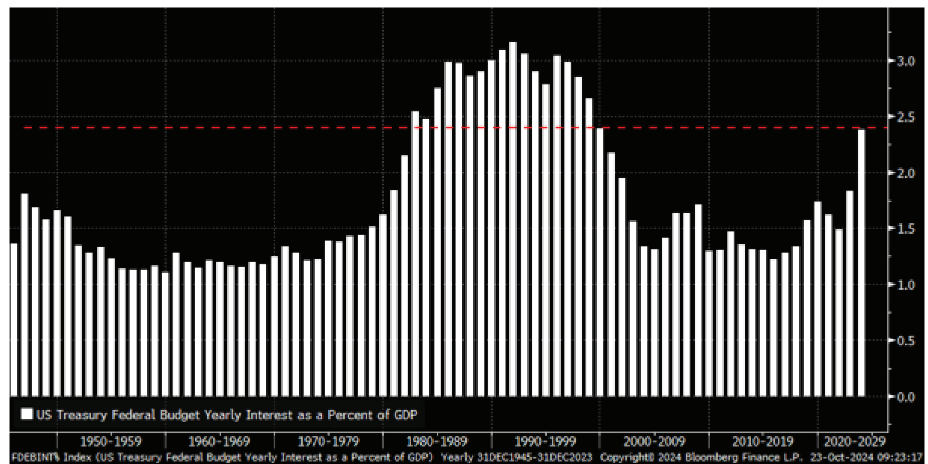
The US debt situation is a very serious, but not dire problem. Cries that the United States is about to fall into a financial apocalyptic abyss seem greatly overdone, but the US economy has indeed been paying a penalty for the government's over-generous spending and tax cuts. US government credit spreads have been abnormally wide for 13+ years.

Some have suggested that the economy's cash flow cannot support the current levels of the Federal debt's interest payments. The country's interest coverage is a viable concern, but the US has in the past had many years when more of the country's cash flow went to supporting Federal debt. Chart 5 shows Federal interest payments as a percent of US GDP. Interest payments as a percent of GDP were higher than year-end 2023's proportion for 17 years during the 1980s and 1990s. There are some dire projections for interest payments as a percent of GDP, but similar pessimism reigned during the 1980s and those forecasts never panned out.

CHART 5:

Federal Interst Payments as a Percent of GDP

(Dec. 31, 1945 - Dec. 31, 2023)



Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.

Perhaps more relevant to the main topic of this report, neither party can be solely blamed for that 17-year period when interest payments were abnormally large because it spanned the Reagan, GHW Bush, and Clinton presidencies.

It is unlikely that the US deficit and debt situation will improve regardless of who wins the upcoming Presidential election. Accordingly, investors should probably fade the election on this issue.

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About Richard Bernstein Advisors

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