February Commentary

The Sun Will Come Out Tomorrow

Before you read something written to the contrary, know this: the sun will come up tomorrow, and the Earth will continue to revolve around it. Despite what many [Debbie Downers](#) are saying, the world will not collapse. None of the dire scenarios, nor for that matter, the fantastical scenarios of a perfect new world, will happen. Everything, including the markets, will recalibrate, refocus, and recover, as they always do.

That said, the recent market volatility hasn't been any fun. But then again, I can't remember a time when market volatility was fun. Thankfully, we haven't had much of it in a long while. I mean, the last couple of years have been pretty straightforward. You just put your money in some large-cap growth or tech fund and did fine. You probably did better than most. However, you secretly suspected the good times would end eventually, right? Now, don't take that last sentence wrong. The red ink and volatility over the previous few weeks have been like an ice-cold glass of water to the face. However, that doesn't mean the fun is over for good. Or that your portfolio will blow up, and your balance sheet will be obliterated forever. Lest we forget, the S&P 500 soared a cumulative 53% over the last two calendar years.

"Tomorrow"—a show tune from the musical Annie, featuring music by Charles Strouse and lyrics by Martin Charnin, published in 1977.

As I type this on Wednesday, March 19, the S&P 500 is down less than 4% year-to-date. As bad as that might be, I suspect many people thought it was worse than that. In fact, over the last 12 months, the index is up over 9%. That isn't too shabby. Here is the bottom line: the economy is cooling off a little from last year's surprisingly strong pace. Add to that the new administration's efforts to slash government spending and their willingness to toss tariffs around like trinkets on a parade route, and you get a decidedly fuzzy economic picture and a jittery market. By fuzzy economic picture, I mean there is a very real likelihood of a negative sign in front of the GDP number for the 1st quarter of 2025. Before you say the sky is falling, a decent chunk of that negative number will be due to an increase in our trade deficit for the quarter. It ballooned during the first two months of the new year as wholesalers stocked their shelves before any tariffs took place. How big of a balloon? In 2024, the average monthly trade deficit was $76.5 billion, with a monthly range of -$66.6 billion to -$98.1 billion. In December, the -$98.1 billion result was the second-highest monthly deficit on record. However, in January this year, the deficit snowballed by nearly $130 billion.

Trust me, businesses were preparing for potential tariffs in 2025 and stocking their shelves accordingly. This shrewd preparation could very well have a troublesome impact on the GDP equation: C + I + G + NX (Net Exports). The C in the equation (consumer spending) will be lower than in 2024, as will the G (government spending). Throw in a large negative number for the NX (trade deficit), as mentioned earlier, and the I (investment) part of the equation will have to surge in 1Q 2025 to avoid a negative quarter to start the year. While the investment (I) part of the equation should be positive due to the increase in inventories, it may not be buoyant enough to keep economic growth afloat for the first quarter. Just a reminder, one negative quarter, if it materializes, does not meet the definition of the dreaded "R-word" - recession. So, is all this uncertainty enough reason to become irrational or climb out on the window ledge? To pour 4-fingers of whiskey and hunker down with the bottle on your porch swing? To blame this person or that person and curse the darkness? I don't think so. The trends in our deficit spending were, and are, alarming.

Depending on your point of view, the first two months of the second Trump administration have been either invigorating or infuriating. They certainly haven't been boring. However, will all the upset apple carts concerning the governmental spending cuts ultimately benefit the country? Will slashing the federal bureaucracy and eliminating what the administration views as wasteful or inefficient benefit the economy? In the short term, I am sorry to say, it probably won't. Firstly, our economy is like a gargantuan cruise ship and maneuvering such a large vessel takes an inordinate amount of time, patience, and skillful piloting. Secondly, there is no way you can potentially eliminate hundreds of thousands of jobs without having a negative impact. Further, all, or most, of the so-called current "inefficient spending" is going to someone, somewhere. The money is being spent somewhere, and that in itself generates economic activity. So, the more dollars that get pared, the less there will be sloshing about in the economy. Ordinarily, more money in the system is better than the alternative.

Now, longer-term? Getting Washington's deficits under control should be good for the U.S. economy. The federal government has proven repeatedly to be less than stellar stewards of our tax dollars, but you don't have to take my word for it. The data is undeniable. At the end of 2014, according to the Bureau of Economic Analysis (BEA), the U.S. Gross Domestic Product (GDP) was $17.9 trillion. By comparison, at the end of 2024, the BEA estimated it was $29.7 trillion. That is an increase of just under $12 trillion in economic growth, which is excellent. Unfortunately, over that same period, the Federal government's debt mushroomed from $18.1 trillion to, get this, $36.2 trillion. That is a vast number and twice as much debt in a relatively brief period! Comparing the two 2024 figures represent a $6.5 trillion difference between solid economic growth and the explosion in debt over the last decade. Where did the money go, and how did we get here? Washington can't keep spending more money than the economy generates in activity. Governments are like individuals in that regard. You and I would unquestionably be filing for bankruptcy at this level of leverage. Let's look at a simple example: Imagine you make $100K/year. Now, for whatever reason, be it good or bad, you borrow $120K at 5% in Year 1. While that might not be ideal, you make more than enough income to pay the $6,000 annual interest. No worries. That one decision shouldn't wreck your entire life. But what if you make and borrow the same amount every year for the next decade? You have accumulated $1.2 million in debt in ten years and are paying $60,000/year in interest. What happens to your lifestyle when most of your income is needed to pay the debt service?

While that analogy might be overly simplistic, the previous administration's last budget would have amassed an additional $19 trillion in debt over the next decade. Of course, that projection made all sorts of assumptions that likely won't come to fruition under the current administration's stated policies. However, I hate to say it, but if the past is prologue, there is no reason to believe that Washington isn't up to the challenge of running up a shockingly high bill, nonetheless. Some will argue that Washington's borrowing from the public through the sale of treasury bonds implies that the interest payments are returned to the economy. In a perfect world, this would be the case. However, according to Statista.com, at the end of 2024, "major foreign holders" owned an estimated $8.5 trillion of U.S. Treasury debt. Further, the Federal Reserve held an additional $6.9 trillion in government-backed securities, and state and local governments owned another large slug, as do insurance companies and banks. In reality, individuals like you and me own a much smaller percentage of the $36 trillion debt pile than you might imagine. As such, all those debt payments would not be going into the wallets of U.S. consumers - at least not directly.

Further, what will happen to the rest of the federal budget if the debt service continues to grow at its current pace? Intuitively, that would mean less money for everything else and hamper the Federal government's ability to deliver the same level of services in the future. As a result, as lovely as it might be to have all the excess dollars sloshing about in the economy, the Treasury's financing costs will continue to squeeze the remainder of the budget to the point of no return. If something doesn't give, it's not a question of ***if***; it is more a question of ***when***.

All this brings me back to the question: "Will slashing the Federal bureaucracy and eliminating what the administration views as wasteful or inefficient produce beneficial results?" Again, in the short term, the answer is probably no. It appears as though many people depend on governmental inefficiency. Cutting waste in and from Washington will result in the loss of many jobs and the jobs that rely on those jobs. I imagine many bar and restaurant owners in DC ("The District") - Arlington, Alexandria, Frederick, Gaithersburg, Rockville, Clarendon, Ballston, Bethesda, Silver Spring, and Reston - have to be concerned. How does it affect their business when their clientele loses their job or fears losing them? However, over the long term, I can't think of any downside to getting our nation's finances back in some semblance of order. Doing so would allow the federal government to continue to provide the necessary services without significant disruption. Further, with less debt in the system, the Treasury should be able to borrow at more advantageous rates, which will benefit the debt service because the less money Washington borrows, the less expensive money will be for you, me, and domestic businesses. That, without question, would help household budgets, economic activity, corporate profitability, and wealth creation. As a result, we have to believe that mitigating inefficient federal spending will produce beneficial results moving forward. I don't see how it can't.

"You can pay me now or pay me later."—the iconic tagline from a Fram oil filter commercial in 1971.

However, you don't go from massive deficits to future benefits without experiencing some discomfort. You can liken it to, say, weaning an overweight person off sugary, nutritionally empty calories. At first, they aren't going to like it one little bit (believe me, I have the T-shirt). Eventually, the benefits will manifest in better health, and they will be thankful they got their diet under control. So, is some short-term volatility worth it while understanding that no one ever likes to see red ink in the markets? Can we stomach a little pain if it ultimately puts the U.S. economy and U.S. Treasury on more sustainable paths? In my mind, this would, could, or should, lead to greater returns in the future. I can't deny that many people dislike the current administration's tactics and approach and strongly disapprove of many of their decisions. However, restraining government spending and controlling the deficit should be of national importance and bipartisan. Not unlike radically changing unhealthy dietary habits, we can either experience some pain over the near-term or a lot of it in the future.

In conclusion, this has been a "glass is half-full" way of describing the equity market's recent unpleasantness. Better things are on the horizon, as they always are. Do you want to know what else is on the horizon? In the morning and out of the East, the sun will rise and usher in a new day. It has been that way since time began, and it will be so for eternity, no matter what we do today and how much we agonize over the noise around us.

Until next month—

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