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STRATEGIC INSIGHT

# DARK CLOUDS ON A DISTANT HORIZON

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The rhetoric surrounding President Trump's tariff initiative has taken on a more philosophical tone. Federal Reserve Chairman Powell, being the latest contributor to the question, "Are tariffs good or bad?" has opined that tariffs usually correlate to slower growth, and free trade policies correlate to higher economic growth. We have commented on tariffs in a similar way, and continue to believe that President Trump's trade tactics are indeed anti-growth.

Nevertheless, we feel it is important to examine tariffs in a more practical sense, trying to look at specific risks and vulnerabilities that exist in our current environment. After all, outcomes can differ depending on the times. In that regard, we can now see "dark clouds" forming in the horizon that bear watching. These dark clouds relate to staggering debt issues worldwide.

The amount of aggregate debt as recently reported by the Institute for International Finance starts at $247 trillion. This number is almost incomprehensible, as I find it difficult to get my mind around $1 trillion let alone $247 trillion.

According to the McKinsey Global Institute, governments account for 43% of this debt while non-financial corporate debt represents 41% of this total. Governments by nature also have massive unfunded liabilities that don't show in the numbers, so we know the real size of the debt load is much larger than the $247 trillion just reported.

The real issue behind these numbers is that debt must be serviced, refinanced, and paid. In order to continue the present momentum in markets, the global economy must simply grow. It is this growth that will prevent default and the likely crash that follows. In each economy there are likely to be different risks and vulnerabilities. In the United States we must look at state and municipal pension plans along with the large number of "junk bonds" currently in income portfolios.

The retirement plans of several of our state governments are literally bankrupt but continue on as acceptable and legal Ponzi schemes, all dependent on municipal government tax revenues to repair the problem.

Moreover, the municipal bond market has a higher risk level itself, as a result of the new tax law, which limits the federal deductibility of state taxes. State and counties that opt for borrowing to cover unfunded liabilities are likely to be surprised as lenders shy away from the municipal market.

In each and every step along the way, the issue is economic growth. Growth must be there in order to avoid a financial train wreck when the debt comes due.

Now, let's consider adding tariffs and political trade wars to this equation. There are unintended consequences which always confront policymakers who advocate for tariffs and trade wars. There are no winners in a trade war, and rhetoric about beating China and Mexico in such a war are simply statements of ignorance.

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Nevertheless, the probability of lower economic growth in this environment is increasing along with the probability of default somewhere within this $247 trillion debt bomb.

Otherwise we look healthy internally.  Economic growth has accelerated to the 4-5% range and corporate earnings by an even greater amount.  Long term interest rates are still low, reflecting a very muted inflation environment. We continue to be optimistic about the outlook for selected companies, preferring to stick with clean balance sheets, reflecting little or no debt, U. S. centric earnings, and minimal exposure to tariffs.  All of our bonds are of the highest quality and "short" in maturity.  We are not comfortable being a lender in this environment.  We have ample cash and will attempt to stay the course and "thread the needle" as we keep an eye on the dark clouds on the horizon.

Please feel free to call us if you would like to discuss these views in greater detail.  As always we appreciate your continued loyalty.

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