Comprehensive Investment Management, LLC
Fee Only Personal Financial Planning
Fall 2023

4th Quarter So Far So Good

Happily, CIM can report that as of November 15th the average year to date returns listed at the bottom of this page are more than twice what was reported to you at the end of the third quarter. Over the past forty five days the S&P 500 stock index has risen 5% and climbed within 6% of its all-time high. In November the S&P has gone up nine of the eleven business days.

What has been driving the stock market is continuing news that inflation continues to come down even a little bit faster than expected. If inflation is under control, then the markets can expect the Federal Reserve to stop raising interest rates and maybe even start making cuts in the rates sooner rather than later in 2024. The markets have been anticipating that scenario for some time and now finally they may have some evidence to back it up.

The bond market has been at the center of Wall Street's sharp swings because higher interest rates and yields hurt prices for all kinds of investments including bonds. See page three for a clear explanation of what bond yields are, how and why they gyrate and their impact on stock prices. In some circles there's talk of a possible Pulitzer for the article, but such talk is probably premature.

Do bonds continue to disappoint? Let's count the ways. Year to date they are squeaking by in positive territory with a return of .8%. That's a small improvement from .3% at September 30, but a big improvement over 2022 when they were down 13.1%. That drop was even higher than large cap stocks that were down 11.5%. With interest rates stabilized, bonds will see better days. We are still waiting for the performance of Treasury Inflation Protected bonds (TIPS) to reflect protection. So far increased interest rates and supply and demand have overshadowed it. TIPS are complicated. The inflation payout is not added until a bond matures. An upcoming newsletter will delve into the intricacies of TIPS.

Recent market and economic activity is newsworthy but usually can be dismissed as "noise" and not indicative of a trend. Investment performance over longer periods, while not predictive, is significantly more meaningful.

Average Annual Returns of Select Mutual Funds

At the close November 15, 2023	YTD	1 Year	3 Years	5 Years	10 Years	15 Years
Large Cap US Stocks	12.9	10.3	9.4	10.3	11.3	14.1
Mid & Small Cap US Stocks	9.3	3.8	2.3	7.1	8.9	14.0
Foreign Stocks	6.4	4.7	-4.2	5.4	5.1	10.3
Intermediate Bonds	.8	1.2	-3.6	1.4	1.7	3.6
High-Yield Bonds	6.3	6.6	.8	3.6	3.9	7.6
Balanced Funds 65/35 bonds/stocks *	10.9	9.9	4.7	8.3	8.0	10.2
Balanced Fund 35/65 bonds/stocks *	.6	1.1	.4	4.3	4.8	7.2

* Over the last 15 years $100,000 in the 65/35 fund grew to $459,000, 56% more than $293,500 in the 35/65 fund.

US DEBT CONCERNS - IF NOT NOW, THEN WHEN?

The debate over the wisdom of establishing a constitutional limit on the country's debt is nearly as old as the nation itself. Thomas Jefferson is often cited as an intellectual forefather in the debate because he had argued for a constitutional amendment taking away the power of the government to incur debt. Realizing later that there is spending and then there is investing, he authorized borrowing $15 million to purchase the Louisiana Territory. The difference between investing versus spending is at the core of good faith debates in Congress concerning government deficits.

While the federal government occasionally ran deficits in the 18th and 19th centuries, that was not the norm. That changed during the Great Depression, after which federal deficits became common. Public support for a constitutional limit averages about 57%. Its popularity trends along with the increasing U.S. debt. The 2023 annual deficit is $1.7 trillion and the cumulative debt $33 trillion.

In February a balanced budget amendment was proposed by Republican Senators Mike Lee and Chuck Grassley. Among the points made, none of which are new, three were prominent. Higher debts requires higher debt service, especially now that interest rates have normalized. There is little incentive for lawmakers to be financially accountable if they don't have to cut programs or increase taxes. And for all the gains realized through economic expansion, out of control debt robs Americans of their future and will impact standards of living.

The counter argument to a balanced budget amendment is that a lack of flexibility would be dangerous. By their nature, economies run hot and cold. A requirement for balance would raise serious risks of tipping a weak economy into a recession and making it last longer and be deeper. It would force policymakers to cut federal programs, raise taxes or both, which is the opposite of good fiscal policy for a weakened economy.

It's agreed that the current path of building debt is unsustainable. Yet, not surprisingly, it will probably take a crisis for Congress to act. It's just a matter of time before global financial markets turn their attention to a possible US default on its debt. The recent rise of the yield on 30-year Treasury bonds is an indication that concern is influencing financial markets. Very recently, the credit rating agency, Moody's, lowered its outlook on US credit from stable to negative. President Joe Biden was not pleased.

If the deficit is not an immediate problem, when will it be? The answer depends on the strength of the US economy. Against many headwinds it continues to be dynamic and vibrant. As long as the economy's growth rate exceeds the growth rate of the debt, economists say we don't need to be too concerned about the deficit. In fact, it may take another 20 or 30 years before serving the debt finally crowds out private investment and slows the economy, certainly affecting some sectors more than others.

Part of the deficit solution, certainly not a popular one, may be to increase revenue. The last time the budget was balanced was in the years 1998 to 2001. The revenue share of GDP was a bit higher than 20%. It's now in the 17% range. Does that necessarily make 20% the right number, higher or lower? No. Those balanced years enjoyed a benign economic period that was boosted by a tech boom and a "peace dividend." Not likely there will be another peace dividend anytime soon. In 2022 global military spending hit a record high.

The bi-partisan Aspen Economic Strategy Group just released a study noting that reducing debt is essential to building a more resilient economy. The group said that by 2053 (yes, that's 30 years from now) the debt ratio to GDP will be 180%, far greater than anytime in US history. Does that mean we have until 2053 to act? No. The sooner incremental changes are initiated the more effective and benign will be the results. The plan includes evidence based bi-partisan ways to rein in spending and increase tax revenue. Government benefits for millions and incentives for business innovation investment and growth are preserved.

It will take forward looking political leadership to implement these ideas. US voters will have to step up and do their part by supporting reform minded parties at the ballot box. Voters will have to do something they don't usually do. Vote against their own pocketbooks.

Bond Interest Rates Versus Bond Yields

First a clarification on the difference between a bond's interest rate and its yield. Written right on the front of a bond you will see its interest rate, face value, issue date and maturity date. None of those features ever change. The face value is the amount the holder of the bond will receive on the maturity date. So everything you need to know about a bond is right there in front of you.

When you buy a new car, the value of the car goes down when you drive off the dealer's lot. You don't care about that because you have no intention of selling the car. You could consider the value of a bond the same way. You have no intention of selling it. You know the interest rate and how much you will receive at maturity.

In fact, whether you plan to sell or not, your bond's value is repriced every business day by the financial markets. The value fluctuates based on, among other things, economic changes, some real, some perceived. The single biggest cause of value change is interest rates, which are set at auctions for newly issued bonds. If the bond you bought on Monday pays 5% and newly issued bonds on Tuesday pay 4.5% then your bond just went up in value. Due to your good fortune, your bond's yield is now lower.

Lower? That's right, its yield is now 4.5%. Yield denotes the bond's value, not to the bond's current owner, but to a potential buyer. A buyer will have to be prepared to offer more than the bond's face value since its 5% rate is higher than the new market rate of 4.5%. The value of your bond went up and its yield went down. Yield and value always move in opposite directions. If you are a bond holder and you hear bond yields went up, then the value of your bond went down. Shares in a bond mutual fund are repriced daily and will reflect the change. There is a silver lining. The mutual fund will be replacing its maturing bonds with those that carry a higher interest rate.

The Interaction of Stock Prices and Bond Yields

In the investment markets, stocks compete with other investments including cash and bonds. Until recently money market funds, bank certificates of deposits and bonds were paying so little, stocks were seen as pretty much the only game in town. Now money markets funds are paying 5% and long-term US Treasury bonds are yielding close to the same with a much longer guaranteed term to maturity. Treasury yields are at their highest levels in more than ten years.

"There's a lot of uncertainty out there these days. Or not. Who knows?"

Investors search for investments with the highest return relative to risk. The recent big jump in bond yields during the third quarter caused stocks to give back their strong gains from the second quarter. At the same time investors are finally accepting the idea that higher interest rates are going to be around for awhile. The rock bottom rates inspired first by the 2008 financial crisis and then the Covid pandemic aren't coming back any time soon. The Federal Reserve is not going to make the mistake of taking its foot off the brake and assume inflation rates on their own will continue to move down to the Reserve's goal of 2%.

Stocks are riskier than bonds, so they are less attractive when bond interest rates rise. The Federal Reserve has indicated it is unlikely to cut rates until sometime in 2024, if then. Higher interest rates make borrowing more expensive for companies, which in turn pressures profits. Ultimately stocks prices are based on expected profits. Higher interest rates also add to the value of the U.S. dollar which is painful for US companies that earn a significant portion of their revenue from abroad.

Bond investors have been suffering from low returns for years. Super low interest rates have boosted stock prices to the detriment of bonds. Bond holders should welcome the return to "normal" interest rates.

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In September the ADV was adjusted as follows: There is no general fee exclusion for money market accounts. Various staff members participate in the preparation of portfolio reviews. Clients may request electronic copies of CIM reports. Clients have the option to pay CIM fees online.

Q & A

Q. Exactly why do they say it would be a disaster if the US were to default on its debt?

A. US Treasury bonds are considered a no risk investment because the agreement to meet its payments are backed by the full faith and credit of the US government. The importance of preserving that aura of stability is why there is much concern when some members of Congress suggest it would be ok for the US to default on its credit obligations.

It's important for any borrower who expects to borrow again to make timely payments. Minimally, a borrower with a record of default can expect to have to pay higher interest rates in the future.

The US government appears to be able to carry the current debt load easily as tax revenues far surpass interest expenses. Since 1950, federal interest payments have been a maximum of about 18% of tax revenue. Currently, that number stands below 10%. It costs the US $395 billion to service its debt last year, according to the Office of Management and Budget. That's around 1% of last year's GDP. Still, economists say debt servicing costs could rise dramatically in the coming years.

In 1917 Congress set a legal limit on the amount of borrowing the Treasury can do. As deficits have continued Congress keeps raising the limit to meet required debt service and new borrowings. By law spending must be authorized by Congress. The argument to raise the limit is that the necessary payment is a result of spending that was authorized. That has been compared to charging a credit card for budgeted expenses and then balking when the bill comes due. It is generally acknowledged that a default would have a catastrophic impact on the US economy, which is why even spending-hawk lawmakers always have come to a last-minute agreement. The Treasury has some flexibility and can prioritize interest payments over other federal expenditures. So, even with recurring episodes of potential government shutdowns due to the debt ceiling debacles, default can be held off at least for a while. But the continued public wrangling sends a message. That explains why Moody's just lowered the outlook for US credit to negative.