BECK MACK + OLIVER

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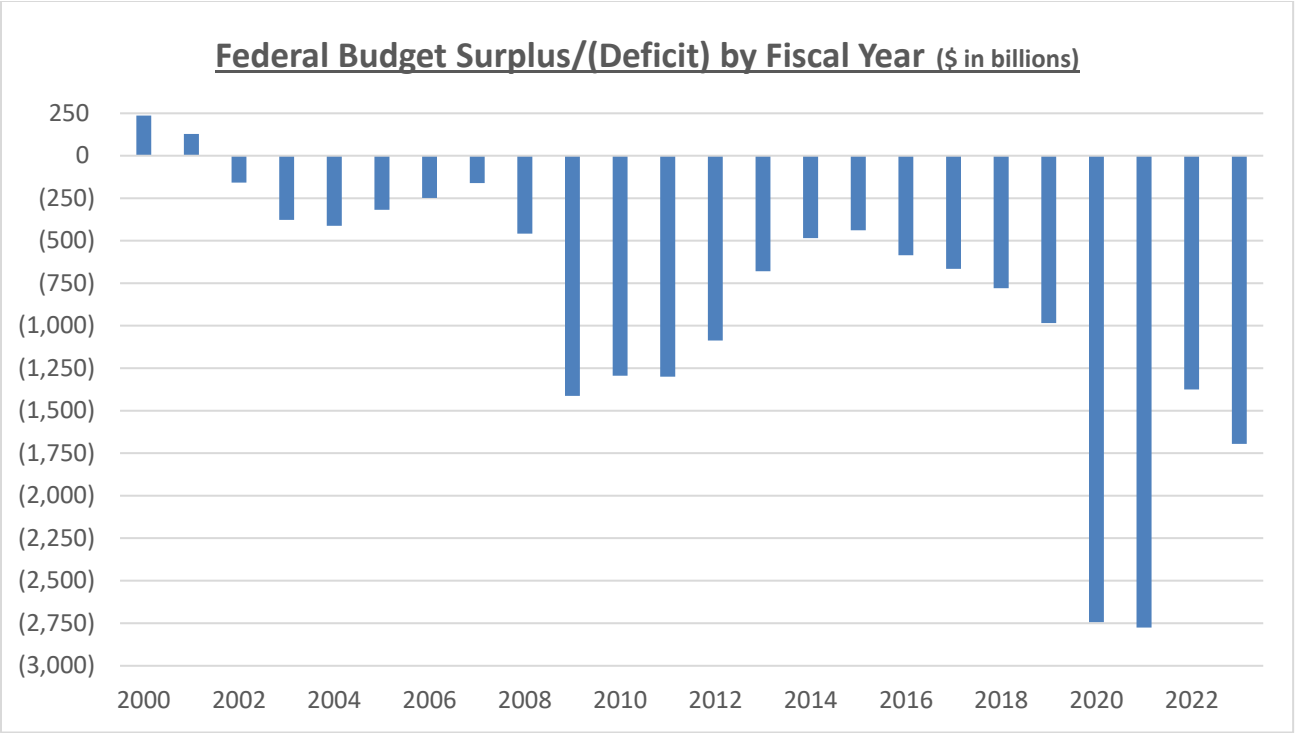
Many clients naturally are wondering what the upcoming election could mean for their investment portfolios. A related, narrower question is what, if anything, are we at Beck Mack + Oliver doing in our client portfolios specifically in anticipation of the election. The short answer to that latter question is "nothing," for the simple reason that we tend not to own businesses whose performance is substantially affected by particular policies—such as subsidies, tax credits, tariffs, or antitrust—over which there is strong partisan disagreement and which are thus subject to abrupt change from one administration to the next.

Part of what makes a business great is its ability to create shareholder value in a variety of economic and political conditions, and we desire to own companies that will be significantly more valuable 5-10 years from now regardless of the electoral outcomes along the way. Public policy can of course affect the rate of economic growth, which in turn influences the rate of corporate earnings growth, hence we as investors are hardly indifferent to public policy. But as we consider the limited stock-specific implications, in our client portfolios, of different potential electoral outcomes—not just the presidency but various executive/legislative branch combinations—and acknowledge the inherent difficulty of predicting future public policy, we are not finding compelling reasons to implement portfolio changes specifically in anticipation of the upcoming election.[1]

There is, however, an issue that is political but not partisan, whose significance is likely to persist far beyond the next administration, and which could materially alter the future financial market conditions under which we invest clients' capital. The federal budget deficit—i.e., the amount by which the federal government's expenditures exceed its tax revenues—is widely perceived to be a problem that has worsened over time and yet it has largely been neglected by those with political power and ignored by the public. The federal government's large and growing deficits have not, in recent memory, had a discernable impact on financial markets, but we believe it is important to understand how and why that could change.

The chart on the following page shows the annual federal budget surplus or deficit since the beginning of this century. The last year in which there was a surplus was 2001. The deficits worsened considerably in the wake of the 2008 financial crisis and then again in the wake of the COVID pandemic, but they have been consistently negative throughout this period, during the vast majority of which the economy has been growing.

[1] On the difficultly of predicting future public policy, we would note that statements made during political campaigns have a way of being superseded by future events, including the truly unpredictable and the predictably messy business of actually passing legislation and enacting policy. Regarding the latter, we are reminded of Otto von Bismark's remark, "Laws are like sausages. It is best not to see them being made."



Any shortfall between the federal government's tax revenues and its expenditures must be funded by the issuance of new government debt, i.e., Treasury securities. Thus, the persistent, large deficits this century have led to an extraordinary increase in the amount of federal government debt outstanding, from approximately $3.4 trillion at the end of 2000 to more than $28 trillion today. As a percentage of Gross Domestic Product (GDP), federal government debt outstanding has more than doubled, from less than 60% at the beginning of the century to more than 120% today. This debt/GDP ratio is useful insofar as it compares the amount of debt outstanding to the underlying economic resources with which we must service that debt, and on that basis our fiscal position has seriously deteriorated. Interest expense on federal government debt, for the first time ever, is expected to exceed defense spending in the current fiscal year.[2]

In beginning to think through the potential financial market ramifications of this fiscal deterioration, it is important to recognize that the government's principal fiscal asset is its ability to raise tax revenue, which is the ultimate source of funding for government spending. Any issuance of debt to fund deficits must eventually be repaid with budget surpluses or the proceeds from new debt issuance. Government debt derives its value from the government's ability to tax. If the government issues too much debt relative to its power to raise tax revenue, then government debt will be worth less, which in practice means higher interest rates and faster inflation.

In order to avoid arriving at that juncture, debt/GDP will have to decline from current levels or at least start expanding less quickly than it has in recent decades. A reduction in the numerator requires greater tax revenue or lower government spending, either of which would probably slow down economic growth and be politically unpopular.[3] If the economy could somehow start growing more quickly, then that would helpfully increase the denominator. From a debtholder's perspective, faster economic growth would mean that the government's fiscal asset, and hence the debt backed by it, are worth more.

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[2] Sources: Department of Treasury; Office of Management and Budget; Congressional Budget Office.

[3] The one political prediction that we are comfortable making is that neither of the two leading presidential candidates is likely, if elected, to expend political capital on improving the US fiscal position.

While government debt is ultimately backed by tax revenue, between the time it is issued and matures it must reside on a balance sheet somewhere. The US is fortunate in that Treasury securities are a financial asset for which there is tremendous global demand, including from foreign central banks, banks and insurance companies, corporate treasurers, broker/dealers, and sundry investors and other financial market participants. Treasurys are perceived to be the safest and most liquid securities and hence the best and most widely used collateral for a range of other securities and transactions throughout the financial system, which makes them a bit like the oil in an engine.

The financial system, however, has only has a certain degree of capacity at any given time, which determines how effectively it can accommodate large or sudden changes in Treasury new issuance or transaction volumes. In order for the system to successfully absorb new Treasury issuance, for instance, there must be enough balance sheet capacity among the purchasers of the newly issued Treasurys. Those buyers may need to create balance sheet capacity by selling other assets, which then need to find a new home, for which capacity in turn may need to be created, etc. If the initial amount to be absorbed is sufficiently large, then it can cause chains of disruption throughout the system. Especially since the 2008 financial crisis, there have been periodic dislocations in fixed income markets, including the repurchase market in 2019 and the broader government bond market in 2020. The Federal Reserve's responses to financial crises and market disruptions over time usually result in its permanently greater entanglement in financial markets.

It would certainly be nice if we could grow our way out of our challenged fiscal position. Perhaps artificial intelligence, whose impact on GDP has thus far been difficult to observe, will eventually turbocharge productivity and lead to sustainably faster economic growth. In the 1990s, the widespread adoption of computer hardware and software and utilization of the internet had a pronounced positive impact on labor productivity, resulting in faster GDP growth, greater tax revenue, and, towards the end of the decade, budget surpluses.

If faster growth is not forthcoming, however, and if politically unpopular tax increases and spending reductions are not implemented, then the debt/GDP ratio might continue to rise, threatening higher interest rates, faster inflation, periodic financial market disruptions, and greater intervention by the Federal Reserve. What would be the implications for how to invest capital in those conditions?

Fixed income investing could become more challenging on account of faster and more volatile inflation. As the amount of government debt outstanding rises relative to the government's tax revenue, bondholders must either believe that the government will find a way to operate in the future with budget surpluses or conclude that the future dollars with which they are eventually repaid will be worth less. If one is buying a 10-year bond, for example, and believes that inflation will be 2-2.5% over the next decade, then one effectively believes that the dollars with which one will be repaid upon the bond's maturity will be worth 78-82 cents—that is, one dollar 10 years from now will be capable of purchasing a basket of goods and services that 78-82 cents is capable of purchasing today. That is quite a different proposition than if one believes that inflation could be anywhere between, say, 5% and 7% over the next decade, in which case those future dollars will only be able to purchase what 51-61 cents can purchase today. After all, "fixed" income means fixed *nominal* income, such that bond investors retain any and all inflation risk until maturity.

Stock investors also retain inflation risk, but with a crucial difference. A stock is a fractional ownership interest in a business, such that it has a claim on the *residual* cash flows of that business. After a business has paid its employees and its other operating costs, and after it has made all required interest and principal payments on its debt, whatever cash flow remains belongs to the stockholders. Faster inflation implies that not only a company's costs but also its revenues will grow more quickly. If a given change in inflation has an identical impact on the growth rates of revenues and costs, then the rate of profit growth will adjust one-for-one with the

change in inflation, leaving stockholders no better or worse off in "real" (inflation-adjusted) terms. The impact of course is not always identical, as different companies have varying degrees of pricing power and fixed-vs.-variable cost structures, but the more general fact that businesses can adjust their prices in the face of inflation mitigates the impact of inflation on real stock returns in the aggregate, whereas inflation represents an unmitigated headwind on real bond returns.

In a potential future environment characterized by higher interest rates and more frequent financial market disruptions, companies that are not particularly reliant on debt financing and that are capable of wisely allocating their internally generated capital should be at a relative advantage over others. As interest rates are the measure of the price, or cost, of capital, when interest rates are elevated the stakes of capital allocation decisions are commensurately higher.

Long-time clients will observe that we prefer businesses with pricing power, strong balance sheets, and smart capital allocation *in any environment.* To the extent that the environment in which we invest becomes increasingly characterized along the lines sketched above—whether due to rising debt/GDP ratios or otherwise—we believe that pricing power, balance sheet strength, and capital allocation will become even more important for determining long-term investment returns.

Partners of Beck Mack + Oliver